H.R. 2990—THE CREDIT RATING AGENCY DUOPOLY RELIEF ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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TUESDAY, NOVEMBER 29, 2005

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

H.R. 2990—THE CREDIT RATING AGENCY DUOPOLY RELIEF ACT

Tuesday, November 29, 2005

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES
WASHINGTON, D.C.

The committee met, pursuant to call, at 10:05 a.m., James A. Byrne Courthouse, Ceremonial Courtroom, Philadelphia, Pennsylvania, Hon. Michael G. Oxley (chairman of the committee) presiding.

Members present: Representatives Oxley, Baker, and Fitzpatrick.

ChairmanOXLEY. The committee will come to order.

Good morning. We are here today in the beautiful City of Philadelphia, the City of Brotherly Love, to focus on H.R. 2990, the Credit Rating Agency Duopoly Relief Act, introduced by Bucks County's own Congressman, Mike Fitzpatrick. I would like to take a few minutes to assess the committee's oversight of the rating agency industry. In response to the largest corporate scandals in U.S. history, Congress passed the Sarbanes-Oxley Act, strengthening the role of gatekeepers, such as auditors and boards of directors, audit committees, and equity analysts.

Another gatekeeper, the credit rating agency, became a focus of Congressional interest because the dominant rating agencies had rated WorldCom and Enron investment grade just prior to their bankruptcy filings. Wanting to understand an industry with such a significant impact on the markets, Congress directed the SEC to study the credit rating industry. Since the release of the SEC's report in January of 2003, the Capital Markets Subcommittee, under the leadership of Chairman Baker and Ranking Member Kanjorski, has held a series of hearings to explore the areas highlighted in the SEC's report about the industry, the barriers to entry, the conflicts of interest, and the lack of transparency regarding rating methodologies.

The SEC, a number of rating agencies, public company trade associations, and academics have all testified before the subcommittee about the industry. Congressman Fitzpatrick's legislation, the Credit Rating Agency Duopoly Relief Act, reflects many of the reform ideas suggested by these witnesses. Witnesses repeated three problems in the credit rating agency industry: the lack of competition, the lack of transparency, and the lack of accountability.

Congressman Fitzpatrick's legislation works to correct all those problems. First, H.R. 2990 fosters competition by simply requiring all eligible rating agencies to register with the SEC. The registra-

tion of credit rating agencies would resemble the registration of broker-dealers and investment advisors under the Federal securities laws. Registration would replace the opaque recognition process the SEC staff now uses to select rating agencies. The designation of only a select number of agencies has led to troubling concentration in the industry, with two firms controlling a vast majority of market share. This is far from an efficient market with robust competition.

The bill takes a further step at encouraging competition by prohibiting anticompetitive practices, such as notching, tying, and unsolicited rating. Smaller rating agencies and public companies have repeatedly alleged that the larger firms engage in such practices. To improve transparency, H.R. 2990 requires the disclosure of procedures and methodologies used in determining ratings, performance statistics, and conflicts of interest. These requirements would go far in shedding light on the operation of these powerful players in the financial markets. In addition, the legislation permits the SEC to adopt further reporting and recordkeeping requirements in the interest of investor protection. And finally, H.R. 2990 enables the Commission to oversee the rating agencies through inspection, examinations, and enforcement actions.

We do hope to pursue this reform in the new year. We are holding this second hearing on the bill to ascertain from our distinguished panel of witnesses their views on and suggested enhancements to Congressman Fitzpatrick's legislation. I look forward to hearing their testimony. I now yield to the gentleman from Louisiana, Mr. Baker, the chairman of the subcommittee.

Mr. BAKER. Thank you, Mr. Chairman. I want to express my appreciation to you for conducting this field hearing and make the observation that when we return to Washington, we really ought to examine the structure of our own committee room. I feel a bit smarter sitting this high up. It certainly is helpful to be up here, I think.

I also want to express appreciation to Mr. Fitzpatrick for the introduction of H.R. 2990. This is a really big issue. As you appropriately pointed out, the rating agencies are essentially the gatekeepers to the capital markets for access by businesses of all sizes to engage in corporate growth and job creation, product development, and all of the things that we see in free enterprise as appropriate and good for our national economy.

A system such as this should be subject to extraordinary scrutiny and held to the highest standards of marketplace accountability. At the current time, I don't believe that can actually be claimed. We have a system which has worked, but markets have changed dramatically. The provision of credit flows differently than any time before in our country's history. Technology continues to press the change, and as a consequence, it is time for us to look at the gatekeeper's role in asserting whether or not there could be modifications made that would benefit all players. It is my view that 2990 brings about an important discussion that we should have engaged in some time ago, but certainly have an obligation to carefully consider the provisions of the bill, as Mr. Fitzpatrick has proposed them.

The current and existing leaders in the provision of ratings would no doubt, after implementation of 2990, remain the predominant providers of ratings in the system, were the system changes brought about as proposed under the Fitzpatrick plan. But certainly, it would give at least regional specialists the opportunity to stay in the oil patch, to do skilled work, and be helpful in bringing about a higher degree of accountability by the major players, not only as to the way in which the work is engaged, but the product quality itself. It shouldn't need to be said again, but probably needs to be said again, that very few sectors of the market performance met our expectations during the Enron-WorldCom days. And to look at the performance of these enterprises in that light, there certainly is hope for improvement in future performance as we make needed changes to the regulatory system.

It is my hope, Mr. Chairman, that the committee will return to Washington sooner rather than later to formally consider the provisions of 2990, move forward on the bill as best we can, and certainly in the course of the hearing today, as witnesses give us their perspectives on how the bill may be enhanced, improved, or otherwise modified, to certainly welcome those comments. It is important that if we are going to have a market-based ratings system that we communicate with the professional leadership of the market in helping structure how that plan should best be implemented.

To that end, I am appreciative for your time in being here in the great City of Philadelphia this morning, Mr. Chairman. Thank you.

ChairmanOXLEY. I thank you and now recognize the gentleman from Pennsylvania, who is the author of the legislation, Mr. Fitzpatrick.

Mr.FITZPATRICK. Thank you, Mr. Chairman.

First, let me welcome Chairman Oxley and Chairman Baker to the City of Philadelphia, sometimes referred to as the Cradle of Liberty, where 230 years ago, not too far from here, some patriots decided to challenge the status quo and make a better life for themselves and for their children. We are certainly very proud of our history in this area, and I am very proud indeed to represent this part of Pennsylvania in the United States Congress. And I also appreciate, Mr. Chairman, you calling this important field hearing today on improving the credit rating industry and allowing me the opportunity to speak on behalf of legislation that I introduced, the Credit Rating Agency Duopoly Relief Act, H.R. 2990.

Credit ratings agencies have been issuing credit ratings on the likelihood of an issuer's default on debt payment since the early 20th century. Today, credit rating agencies rate not only companies, countries, and bonds, but also assets and securities, collateralized debt obligations, commercial paper, private placements, certificates of deposit, preferred stocks, medium term notes, and shelf registrations. Despite being often underestimated and overlooked, their power is indeed immense. Credit rating agencies have a great impact on the bottom line of companies, municipalities, and school districts. The better the credit rating, the lower the interest rate that the borrower must pay.

This expansive influence finally came into question on account of the recent corporate scandals and the fact that two of the largest nationally recognized statistical rating organizations, NRSROs,

Standard & Poor's and Moody's, rated Enron and WorldCom at investment grade just prior to their bankruptcy filings. Essentially, they told the market that Enron and WorldCom were safe investments, even though their problems were very apparent to the marketplace. As a result, reforming the rating agency industry has been the subject of much debate in the House Financial Services Committee.

Before being elected to Congress last year, for 10 years, I served as a county commissioner in the county just north of here, Bucks County, and many of my constituents held stock in Enron and WorldCom, and they were greatly impacted by their bankruptcies, just as countless others were across the Nation. S&P and Moody's' monitoring and reviewing of Enron and WorldCom, in my view, fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance.

Today there are over 130 credit rating agencies in the market. However, only five are designated as an NRSRO by the U.S. Securities and Exchange Commission. The SEC coined the term NRSRO without defining it in its 1975 rule on net capital requirements when an obligated broker-dealer is to hold more capital for those bonds rated junk by an NRSRO. Since then, other regulators and the private investment community have taken up the term also, though, without defining it. Over the past decade, the SEC has issued various releases, reports, and proposals relating to the NRSRO designation process and credit agency reform generally. In 1994, the SEC issued a concept release stating that the most important factor is that the rating agency be nationally recognized, that is, considered by the financial markets to be an issuer of credible and reliable ratings. In 1997, the SEC issued a proposed rule to codify the requirements for designation outlined in the 1994 release, but the SEC failed to implement the proposal. A possible reason is that the Department of Justice objected to the proposal's requirement that NRSROs be nationally recognized, that that would have been anticompetitive, prohibiting the entry of new market participants.

The SEC's national recognition system is the root of the problem. The NRSRO process is practically an insurmountable artificial barrier to entry. Credit ratings matter only if they are issued by an NRSRO; thus, since debt issuers typically seek ratings from NRSROs to comply with a regulation or a contract, a rating agency's lack of designation significantly hinders its ability to garner the national recognition required to obtain status. This difficulty in obtaining the NRSRO label, due to the nationally recognized requirement and the lack of clarity in the designation process, has created a chicken and the egg situation for non-NRSRO credit rating agencies trying to enter the credit rating agency, further fostering a duopoly in the credit rating industry.

The credit ratings industry is dominated by S&P and Moody's. Together, they have over 80 percent of the market share. Under the leadership of Chairman Oxley and Subcommittee Chairman Baker, the House Financial Services Committee has received testimony that the lack of competition in the rating industry has lowered the quality of ratings. They have inflated prices. They have

stifled innovation and allowed conflicts of interest and anticompetitive practices to go unchecked.

I introduced the Credit Rating Agency Duopoly Relief Act to inject greater competition, transparency, and accountability in the credit rating agency industry through market-based reform. It enhances investor protection by replacing the SEC's opaque designation scheme with a more thorough, transparent registration process that protects investors. Instead of allowing public companies and investors to decide whose ratings to use, the SEC decides for them under the current regulatory regime. Ironically, the same regulatory agency that freely allows individual investors, regardless of their sophistication, to choose a mutual fund, steps in and refuses rating consumers the same freedom of choice. Stranger still is the fact that most of the consumers of ratings data are institutional investors, sophisticated actors in the investment community.

Given the current regime, it comes as no surprise that more often than not, the SEC decides to force consumers to use the two largest agencies in the market, S&P and Moody's. My legislation would eliminate the SEC staff's anticompetitive NRSRO process. H.R. 2990 would ensure a level playing field for all rating agencies. All eligible credit rating agencies would be registered with the SEC under the Securities Exchange Act of 1934. Any credit rating agency meeting the definition of a statistical rating organization must register with the SEC. To become eligible for and comply with registration as a nationally registered statistical rating organization, companies must be engaged in the business of issuing credit ratings for at least 3 consecutive years prior to filing an application for registration. In addition, this new definition does not discriminate against certain business models, as the SEC currently does in its current definition process, but instead accepts firms with a purely quantitative model and investor fee-based model.

As an additional protection for investors, the Act would also prohibit anticompetitive industry practices and mandates reporting and recordkeeping requirements for registered firms, similar to those for mutual funds, investment advisors, and brokers. A nationally registered statistical rating organization will be required to disclose in its registration application not only its long and short term record at rating securities and public companies through performance statistics, but also the methodologies it uses in deriving its ratings and the conflicts its business model raises and the manner in which it manages those conflicts. The Credit Rating Agency Duopoly Relief Act directs the SEC to develop other reporting requirements as it deems appropriate in the interests of investor protection. Moreover, registered rating agencies will be held accountable under the securities laws. The SEC will be able to inspect, examine, and bring enforcement actions against rating agencies under the 1934 Act. My legislation incorporates most of the SEC staff's proposed outline of the regulatory framework.

A minority of commentators have claimed that any registration in this industry amounts to a violation of First Amendment privileges. H.R. 2990 does not infringe upon those privileges. The legislation neither bans nor restricts First Amendment rights in any manner whatsoever. The Government has an undeniable interest

in registering rating agencies, given the credit rating industry's substantial effects and impact on the market.

My legislation regulates the credit ratings industry through disclosure, which is the least restrictive means of regulation. It is important to note that currently, all five SEC approved agencies already registered voluntarily under the Investment Advisors Act of 1940. By encouraging competition in the industry, prices and anti-competitive practices will be reduced, credit ratings quality will improve, and firms will be required to innovate. H.R. 2990 presents a commonsense, market-based approach to reform, the basic problems of the credit ratings industry, while protecting our robust marketplace.

Chairman Oxley and Subcommittee Chairman Baker, thank you for your continued leadership in the credit rating industry, and I yield back the balance of my time.

ChairmanOXLEY. I thank the gentleman and want to also congratulate him for his excellent work on this important subject. The committee, as all of us have indicated, since the fall of Enron, WorldCom, has really concentrated on what I guess we would consider the gatekeepers over time, and this is one of the areas that we felt really needed some attention, in terms of more transparency, more competitiveness, and the like, and the committee will proceed, when we return in January, with a markup on your legislation.

Let us now turn to our distinguished panel of witnesses. We thank all of you for coming here today to Philadelphia to participate: Mr. Glenn Reynolds, chief executive officer of CreditSights, Inc; Mr. Paul Schott Stevens, president of the Investment Company Institute; Mr. Richard Y. Roberts, partner of Thelen Reid & Priest LLP, on behalf of Rapid Ratings Pty Ltd.; Mr. Jonathan R. Macey, Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law, with the Yale Law School; and Mr. Sean Egan, managing director of Egan-Jones Ratings Company.

Mr. Reynolds, we will begin with you.

STATEMENT OF GLENN REYNOLDS, CHIEF EXECUTIVE OFFICER, CREDITSIGHTS, INC.

Mr.REYNOLDS. Thank you. It is my pleasure to be here this morning.

My name is Glenn Reynolds. I am the CEO of CreditSights. We are an independent research firm offering a range of research and data products and with a heavy focus on credit research. Our primary business is not credit ratings, however, but we do compete with some of the rating agencies in some areas. We probably chose a different business model than credit ratings, since entering the ratings business was essentially impossible under the current regulatory framework. Based on our current business model, we are a registered investment advisor regulated by the SEC in the U.S. and by the FSA in the UK.

We have had the opportunity to testify before on the rating agency topic in front of the Senate in March 2002, and the SEC in November 2002, and it has been interesting to watch the process evolve. A lot of man hours have been directed at this issue. A lot of hearings have been conducted, a lot of testimony filed. The level

of due diligence has been impressive. It is clear that many parties have a strong interest in seeing some progress made and have a lot at stake in the issue. It is equally clear that some parties have a big stake in seeing no action.

With 4 years since the Enron fiasco and various other market implosions now behind us, it is also clear that there has been dramatic change in the securities, banking, and accounting industries as we all moved ahead and learned from past experiences. It is safe to say that this has not been with the credit agencies. The banking and brokerage industry had paid out billions of dollars, totally overhauled their approaches to research, addressed conflicts of interest, and altered compensation strategies to deal with some of the well-documented issues. The accounting profession has also seen sweeping changes in the industry. Business lines have been reorganized. Entire firms have disappeared. The ruling accounting bodies have made sweeping changes in disclosure and accounting requirements. In the broader market, corporate management teams are now under more stringent guidelines to take responsibility for their financial statements and internal controls.

Remarkably, the one major segment of the capital markets that remains on structural cruise control through all of this change is the credit rating agencies, or more narrowly, the NRSROs. The NRSROs have somehow been able to slow the pace of change, frustrate the timely lowering of artificial barriers to entry, and continue to expand into non-ratings business lines at breakneck pace from their protected enclave as an NRSRO. They remain largely insulated from competition by an outdated and anachronistic regulatory framework that the overwhelming majority of reasonable people, disinterested or otherwise, see as overdue for an overhaul to allow more competition. The agencies have mounted the usual defenses, but some facts of life have to be clear. The rating agencies are, in fact, a major force in the capital markets, and they toe the line between being an information provider and a de facto part of the underwriting process. The regulations have woven the rating agencies in the fabric of the securities markets, and the agencies have taken every opportunity to tighten the stitching. They hold sway over many capital market segments, and most of the major trade groups and individual companies are not going to mess with them publicly.

Every next move influences mark-to-market adjustments, reserve requirements, asset allocation decisions, forced sale of assets, and access to the capital markets generally. They are unique in that position and being essentially devoid of meaningful regulation. They have a sweet regulatory deal, and that brings us to H.R. 2990. H.R. 2990 will immediately address the issue of barriers to entry and start the process of injecting some competition into the ratings sector. As the debate continues, it may also shine some light on the array of non-ratings businesses that the rating agencies are entering, all the while as they are structurally protected in their main credit rating business. As it stands today, an unlevel playing field has undermined economic efficiency, kept prices artificially high, limited innovation, tapped the brakes on quality, and limited diversity of opinion in the marketplace. Competition does not cure all ills, but historically, has sure proven to be a good start. H.R. 2990

gives it that fresh start. There is no doubt that, if passed, we will see more competition.

We can state clearly from our own experience at CreditSights that both strategic operators in the financial media space and sources of private equity capital see investment opportunities in the credit ratings, financial information, and financial data space. H.R. 2990 will open up the opportunities, and change will come fast. H.R. 2990 is pro-competition, and it is also rational. It will lower the artificial barriers to entry and allow market entrants to tackle the natural commercial barriers to entry which are demanding enough. The longer the artificial barriers remain up, the higher the natural barriers will be stacked by Moody's and S&P. The ratings industry is, if anything, not a natural duopoly or even a natural oligopoly. In fact, it should be naturally competitive, just like the brokerage industry, the banking industry, the asset management industry, and the media industry. Those industries only get more competitive. The ratings industry is in stark contrast. With Moody's and McGraw-Hill posting remarkable financial performances, exception profit margins, especially in their financial businesses at McGraw-Hill, and generally dwarfing the stock returns of the overall market in the broader peer group of financial companies, it is worth asking why we have not seen major market entrants. Economics 101 tells us something is wrong. That is where the artificial barrier part comes in. It is intuitive and obvious that market competition is being held back artificially. Scrapping the NRSRO designation entirely is preferable to the status quo, but some regulation still is prudent, and the disasters of 2001 and 2002 are there to remind us of that. We realize that the NRSROs are mounting a furious defense against even light-handed regulation after years of being essentially protected by regulation and generating massive financial benefits from the regulation that kept out competitors.

We would refer you to our formal testimony on some of those issues, but a few things are clear. The rating agencies win by delay. H.R. 2990 speeds up the process and does so with a measured series of steps. It could use some definitional tweaking, but has all the right parts to get a little resolution to the dilemma. The market holds more opportunities today than ever in the credit markets for rapid growth, and competition will flourish. Moody's and S&P would like to keep the status quo to capture a bigger slice of that growth. Large firms and small firms are waiting in the wings. The interests of the duopoly will be for more delay or to water down the bill. They will propose to make it voluntary or promise a fight. They never offered to make entry voluntary over all these years as they frustrated competition. The policy decision here either calls for a major force in the capital markets to be free of all regulation or not. Moody's and S&P will try to make this about the First Amendment. The agencies, on the one hand, would have you believe their views are like a good or bad movie review in Variety. We cannot even believe they can seriously and truly believe this is about journalism.

Philadelphia is a great place for these hearings, to drive home the points that this is not about the Constitution. Then again, Philly is the right place, since this is all about the Benjamins. It

is about profit, and it is about who gets it. It is about choice and not having it. In some ways, it is that simple.

Thank you to the committee for the opportunity to weigh in on these issues.

[The prepared statement of Glenn L. Reynolds can be found on page 42 in the appendix.]

ChairmanOXLEY. Thank you, Mr. Reynolds. Mr. Stevens.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr.STEVENS. Mr. Chairman, thank you, and I am delighted to be able to join the committee here in Philadelphia this morning.

As you know, I head the national association of U.S. Investments Companies, and our members include both open-end companies, or mutual funds, closed-end funds, exchange-traded funds, and sponsors of unit investment trusts, and the credit rating agencies are important to each and every one of these classes of our members. Our mutual fund members have assets of $8.5 trillion, representing more than 95 percent of all U.S. mutual fund assets. They serve about 87 million shareholders and more than 51 million households.

The Institute commends the Financial Services Committee for holding this hearing on H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005, which is intended to improve the quality of credit ratings by fostering competition, transparency, and accountability in the credit rating industry, and to address concerns regarding the current NRSRO designation process. This is my second opportunity as president of the ICI to testify before the committee which you have so ably led, Chairman Oxley. Under your leadership, and that of Ranking Member Frank, and Capital Markets Subcommittee Chairman Baker, and Ranking Member Kanjorski, the committee has been active in critically important issues affecting all aspects of our capital markets. This legislation is one more example, and I would like to recognize Congressman Fitzpatrick for his leadership in advancing this important bill.

Credit rating agencies play a significant role in the U.S. securities markets generally, and other of the witnesses will talk about that. I would like to address their importance vis-a-vis mutual funds in particular. Mutual funds employ credit ratings in a variety of ways: to help make investment decisions, to define investment strategies, to communicate with their shareholders about credit risk, and to inform the process for valuing securities.

The most significant influence of credit ratings on the fund industry is on the $2 trillion invested in money market mutual funds. Money market funds are a truly remarkable chapter in the history of U.S. mutual funds. Initially, they were used as savings vehicles. Today, retail and institutional investors alike rely on them as a broader cash management tool because of the high degree of liquidity, stability, of principal value and current yield that they offer. ICI estimates that between 1980 and 2004, roughly $100 trillion, a staggering number, flowed into, and the same amount out of money market funds.

Now if the money market fund industry is a success story for Institute members, money funds are also, most certainly, an SEC

success story as well. Since 1983, money market funds have been governed very effectively by Rule 2a-7 under the Investment Company Act of 1940. Rule 2a-7 limits the types of securities in which money market funds can investment in order to help them achieve the objective of maintaining a stable net asset value of one dollar per share. Credit ratings form an integral part of these limitations. For example, money market funds may only invest in securities either rated by an NRSRO in its two highest short-term rating categories or if the securities are unrated, they must be determined by the fund's board of directors to be of a quality comparable to such rated securities.

Now it is important to note that no Government entity, such as the FDIC, insures money market funds. Nevertheless, despite an estimated $200 trillion flowing into and out of these funds over the past 25 years, through some of the most volatile markets in our history, only once has such a fund failed to repay the full principal amount of its shareholders' investments. In that case, many years ago, a small institutional money fund broke the buck due to extensive derivatives holdings.

It is critically important that this record of success achieved under Rule 2a-7 continues for the benefit of money fund investors. This, in turn, depends upon the ratings issued by NRSROs providing credible indications of the risk characteristics of those instruments in which money market funds invest.

To promote the integrity and quality of the credit ratings process and, in turn, serve the interests of investors who use credit ratings, we believe that there are several steps that should be taken. First, the NRSRO designation process should be reformed to facilitate the recognition of more rating agencies and, thereby, introduce much needed competition in the credit rating industry.

The mutual fund industry is one in which intense competition has brought unparalleled benefits to investors. I firmly believe that robust competition for the credit ratings industry can do the same and is the best way to promote the continued integrity and reliability of credit ratings. Unfortunately, the current designation process does not promote but, in fact, creates an affirmative barrier to competition. In particular, the current SEC process for designating credit rating agencies through the issuance of no action letters has not worked effectively. In place of this no action process, the Institute recommends mandatory expedited registration with the SEC. We are, therefore, pleased that H.R. 2990 properly moves the basis for NRSRO designation from a national recognition standard to an SEC registration requirement.

Second, there should be appropriate regulatory oversight by the SEC to ensure the credibility and reliability of credit ratings. We believe this can be achieved through a combination of one, periodic filings with the SEC and, two, appropriate inspection by the SEC coupled with adequate enforcement powers. Specifically, H.R. 2990 would require that certain important information be provided to the SEC upon registration. We believe that NRSROs should be required to report to the SEC on an annual basis that no material changes have occurred in these areas. Similarly, NRSROs should be required to report any material changes that do occur on a timely basis, and this information should be made available promptly

to investors who rely on NRSRO ratings. Such disclosures should be accompanied by an appropriate SEC inspection process tailored to the nature of their specific business activities.

Third, investors should have regular and timely access to information about NRSROs to provide them a continuous opportunity to evaluate the ratings that they produce. In discussions with our members, they have emphasized the importance to them, as investors, of access to information about an NRSRO's policies, procedures, and other practices relating to credit rating decisions. In particular, it would be helpful for NRSROs to disclose to investors their policies and procedures, addressing conflicts of interest, as well as the conflicts themselves, and periodically to disclose information sufficient for investors to evaluate whether they have the necessary staffing, resources, structure, internal procedures, and issuer contacts to serve effectively as NRSROs.

Finally, we believe NRSROs should have some accountability for their ratings in order to provide them with incentive to analyze information critically and to challenge an issuer's representations. Specifically, we believe that any reforms to the credit ratings process should, at a minimum, make NRSROs accountable for ratings issued in contravention of their own disclosed procedures and standards. Even if the First Amendment applies to credit ratings, it does not, in our view, prevent Congress from requiring rating agencies to make truthful disclosures to the SEC and to the investing public.

Now the SEC has been aware of issues relating to credit rating agencies for over a decade now. During that time, it has issued two concept releases, two rule proposals, and submitted a comprehensive report to Congress addressing credit rating agencies and NRSRO practices. In the process, the Commission has received scores of comment letters, including several from the Institute, urging action in this area. No action has been forthcoming. In light of this history, we believe action by Congress is now necessary. The Institute strongly, therefore, supports the goals of H.R. 2990: increased competition, appropriate SEC oversight, greater transparency, and heightened accountability. These are the right objectives for reform of the credit rating industry from the perspective of mutual funds, other investment companies, and other investors, and, indeed, the securities market as a whole.

I very much appreciate the opportunity to share the Institute's views with you today. We have a number of technical comments about the bill that we will be providing separately, and we do look forward to working with the committee on these and other issues in the months ahead.

Thank you, Mr. Chairman.

[The prepared statement of Paul Schott Stevens can be found on page 68 in the appendix.]

ChairmanOXLEY. Thank you, Mr. Stevens. Mr. Roberts.

STATEMENT OF RICHARD Y. ROBERTS, PARTNER, THELEN REID & PRIEST LLP, ON BEHALF OF RAPID RATINGS PTY LTD.

Mr.ROBERTS. Mr. Chairman, I appreciate the opportunity to appear today on behalf of Rapid Ratings. I am Rick Roberts. I am an attorney in Washington, D.C., with the firm of Thelen Reid &

Priest. The views that I express today are to be considered my own and do not necessarily represent those of my law firm or the clients of my law firm. Matter of fact, if the views are not well received, I will disclaim them as my own after the hearing.

From 1990 to 1995, I was privileged to serve as an SEC Commissioner. During my SEC life, in a couple of speeches in 1992, I highlighted what I viewed as the potential problems imbedded in the NRSRO designation criteria utilized by the SEC. First and foremost among them is that that acronym really stinks, and it needs to be a lot shorter. It is very hard to pronounce. Unfortunately, not much has changed since 1992. I believe that H.R. 2990 will introduce much needed competition and additional integrity to the rating process for debt securities and will reduce systemic risk in the marketplace. In my view, H.R. 2990 will serve as a catalyst for reforms that will greatly enhance the quality of information provided to investors.

It may be helpful if I talk for a few minutes about Rapid Ratings. Rapid Ratings is an organization founded in 1997 and is an independent global corporate credit rating agency headquartered in Australia, with other offices in New Zealand, Singapore, the UK, Canada, and the U.S. Rapid Ratings is currently licensed by the Australian Securities and Investment Commission as a credit rating agency to provide financial advice to wholesale and retail markets. Rapid Ratings anticipates that it will file an application seeking to obtain NRSRO designation with the SEC in the near future.

Using proprietary software, Rapid Ratings rates approximately 15,000 listed companies globally, including 7,000 in the U.S. Rapid Ratings follows the original rating agency model of being paid by buy-side subscribers, rather than by issuers of securities. Unlike current NRSROs, Rapid Ratings credit ratings assess the financial health of an institution based on industry-specific quantitative models, and the ratings are derived solely from publicly disclosed financial statements.

The current NRSRO criteria were designed for rating agencies with an issuer-paid business model, despite their origins of being paid largely by subscribers. Since NRSRO status was introduced in 1975 for net capital rule purposes, the largest rating agencies have been increasingly and now predominantly paid by issuers of debt to rate those parties, and I refer to this as a Type 1 business model. This was, perhaps, one of the unintended consequences of the creation of NRSRO status. Type 1 rating agencies employ highly skilled and highly paid people that go onsite to acquire nonpublic information to rate companies. New generation rating agencies, such as Rapid Ratings and many others, have an entirely different business model, which I will refer to as the Type 2 model.

New generation rating agencies are paid by investors or other buy-side third parties, such as banks, insurance companies, mutual funds, pensions funds, large creditors, et cetera, to rate second parties, such as listed and/or unlisted companies and their securities, and use only publicly available information. Type 2 rating agencies also typically use software rather than analysts. Thus, in the Type 2 model, there may be no contact between the rating agency and the companies it rates and, thus, little potential for conflict of interest. In assessing eligibility for NRSRO status, it would be unfair

to require a Type 2 company to conform to criteria that pertain only to Type 1 companies that have such conflicts.

Now Rapid Ratings believes H.R. 2990 would achieve many of the goals that are necessary to promote greater efficiency in the debt markets. It would remove most of the current restrictions, instituting a registration process for rating agencies that have been in business for more than 3 years, and substituting ″registered″ for ″recognized″ in the NRSRO acronym. It also would permit quantitative firms to be registered and would allow subscription fees to be charged for ratings by not requiring wide dissemination of ratings at no cost. Thus, the legislation will ensure that the pre-1975 practice of having the ratings largely paid for by investors and other buy-side subscribers is revived by new generation rating agencies with new technology and a strong record for providing early warnings to the market. This bill, if enacted, goes a long way toward removing the barriers to entry created by the current regulatory standards while assuring the integrity of the rating process by providing credible market-based standards.

And in conclusion, I believe, as I always have, that regulation is no substitute for competition in the marketplace. Consumer choice is often the best policeman. In my opinion, the real potential for enhancing ratings competition arises with the entry of innovative rating agencies that offer alternate business models. If a level playing field is created to permit Type 2 rating agencies with innovative business models that are paid by investors to compete effectively with Type 1 rating agencies that are paid by issuers, there will be, in my judgment, significant benefits to the marketplace, and these benefits include earlier warnings to the market of potential problems, enhanced protection and choice for investors, greater accuracy in ratings, broader coverage of securities and issuers, lower costs to issuers and investors, greater independence and objectivity, and less risk of systemic shocks. In my view, the reduced barriers to entry afforded by H.R. 2990 will provide substantial benefits to the market and will improve the efficiency of the capital allocation process.

Again, I appreciate the opportunity to participate in the hearing, and I will be happy to attempt to respond to any questions that you may have at the appropriate time.

[The prepared statement of Richard Y. Roberts can be found on page 51 in the appendix.]

ChairmanOXLEY. Thank you, Mr. Roberts, for your testimony. We now have Professor Macey.

STATEMENT OF JONATHAN R. MACEY, SAM HARRIS PROFESSOR OF CORPORATE LAW, CORPORATE FINANCE, AND SECURITIES LAW, YALE LAW SCHOOL

Mr.MACEY. Thank you. It is a pleasure to be here, and Chairman Oxley and Subcommittee Chair Baker and Congressman Fitzpatrick, I am delighted to be here.

The previous four speakers did a great job and said a lot of the—made a lot of the points I was going to make, so I will try to focus on some new and different aspects. But let me begin by saying that I think the statute proposed, H.R. 2990, provides a very valuable legislative framework that will promote more vigorous competition

in the rating agency business and provide not only better ratings, but also provide strong protections for individual investors. I would add to that that I think the statute is very simple, elegant, well tailored to the problem, so I think that it is something that I strongly support.

There is this strange puzzle in the—those of us who study credit rating agencies often observe, which is, as was pointed out earlier, we see an industry that makes tremendous amounts of profits, but at the same time, seems to do a really bad job, as we see with respect to the performance of rating agencies in contexts like Mercury Finance, Orange County, Pacific Gas & Electric, Enron, WorldCom, and more recently, the lagging ratings for companies like General Motors and Ford. And I think that there was nothing unintentioned, or there is nothing intentioned, rather, or evil in the way this developed. I think it was basically inadvertent that the NRSRO designation evolved in such a way that it created an artificial demand for ratings and people in the financial marketplaces, as was the case with the example earlier of Rule 2a-7 of the Investment Company Act of 1940. It created a demand for ratings regardless of the content or quality of those ratings. We have very little competition in that area.

So I fully support this statute. I want to just say in a couple of additional points. One is while I certainly agree that there have been drastic improvements in—since the sort of Enron era, I don't think it is the case that the credit rating agencies are the only sort of noncompetitive node in the capital markets, that the GAO has, I think, amply demonstrated the lack of competition among the remaining four accounting firms for auditing large U.S. companies, stock exchange specialist firms, bulge bracket underwriting firms. Self-regulatory organizations in the financial markets are also like the current NRSRO situations where in a perfect world we would spend time thinking about how to make those areas of the capital markets more competitive. The nice thing about the credit rating agency problem, if you will, is that we have before us a very, I think, discrete functional solution, and it is a terrific, terrific place to start. I would just urge this committee to continue down this very good path towards making capital markets more competitive.

A couple of other points. One is on the First Amendment issue. Let me just say that generally speaking, I think this is a complete red herring. If this statute violates the First Amendment, then I think the Securities Act of 1933 registration requirements for initial public offerings also violates the First Amendment, so we could stop IPOs. I don't think either one of them does. I think that is simply a red herring put forth by people who want to, for obvious economic reasons, to maintain the current status quo.

One kind of footnote to that is, one aspect of this statute would prohibit the newly created registered rating organizations from issuing unsolicited or free ratings. I think that, given the other changes in the bill, I am not sure that is necessary. I do agree that unsolicited ratings are a very big problem. There is this issue of whether rating agencies engage in shakedowns of companies and municipalities in the market for credit. Do agencies demand payment by companies and municipalities for ratings? If that is the case, I certainly think that there should be regulatory action taken

against the rating agencies. I also think that rating agencies should be required to disclose when the ratings they issue are unsolicited, and they should also be required to disclose when they are offering services on a fee basis to the entity being rated, but were declined, and I think that the agencies similarly should be required to disclose whether information on which their ratings are based is as complete in the case of an unsolicited rating as information that they ordinarily possess when generating a solicited fee paid rating. But I am not sure I would go as far as the legislation goes and require—and ban unsolicited ratings.

Last is, I certainly support specific features of the legislation that would require disclosure of conflicts of interest and the procedures and methodologies used in determining ratings, as well as the procedures used to prevent the misuse of nonpublic information. I would be—certainly, though, you would want to—we would want to be careful in implementation that, to the extent that companies have developed proprietary trade secrets, which would be of use to rivals, with respect to the ways that financial data is analyzed, and for the generation of a rating, we would want to protect that property right.

But with that said, I think—excuse me, 2990 is an important and valuable statute, which I will hope will pass, and will improve the quality of the information provided by credit rating agencies and establish credit rating agencies as an important component in the U.S. system of corporate governance and investor protection.

Thank you.

[The prepared statement of Jonathan R. Macey can be found on page 37 in the appendix.]

ChairmanOXLEY. Thank you very much, Professor. And our final witness is Mr. Sean Egan. Mr. Egan.

STATEMENT OF SEAN EGAN, MANAGING DIRECTOR, EGAN-JONES RATING CO.

Mr.EGAN. Thank you. I am Sean Egan. I am managing director of Egan-Jones Ratings.

We support the proposed legislation for reforming the rating industry, since it significantly increases competition.

The primary purpose of rating firms is to facilitate the allocation of capital by assessing the relative riskiness of various issuers. The job can be compared to the trucking industry, in the sense that capital, rather than goods, are moved throughout the financial system. Unfortunately, the regulatory process for the trucking industry makes a great deal more sense than does the regulatory process for the rating industry. In the trucking industry, there are various tests drivers need to take to ensure that they are able to operate vehicles in a safe manner. The tests are straightforward, and passing them is similar to passing a driving test. In the rating industry, there has never been a formal process for obtaining a license, and at the current rate, there never will be. Regulators have been studying the area since the early 1990s and have yet to establish a set of requirements for applicants. Yes, two firms in the past couple of years have been recognized, but for the most part, the firms provide little competition to the major firms in the industry, S&P

and Moody's. DBRS rates mainly Canadian issuers, and AM Best focuses on insurance firms.

In the trucking industry, if a shipper is unhappy with the rates or service of one particular shipper, there are a variety of other shippers available. In contrast, in the rating industry, there is relatively little competition. S&P and Moody's garner approximately 85 percent of the revenues for U.S. corporate debt, and a rating from two firms is normally needed for a public issue. The costs for the lack of competition is borne by issuers, investors, employees, retirees, and non-recognized rating firms.

To address some of the concerns that have been raised about H.R. 2990, facilitating the emergence of a plethora of unqualified rating firms, we recommend the following additions to Section 3(a) of the Act—of the bill.

Independence. No NRSRO shall be affiliated with a broker-dealer, bank, financial institution, issuer, investor, or user of credit ratings. Experience. The rating firm shall have issued ratings for the past 7 years and shall have generated at least $1 million in revenues from such activities in the U.S. for a period of 7 years or more. Quality. To reflect the impact of events such as acquisitions, major share repurchases, and buyouts, all ratings issued will be reviewed using qualitative methods. Additionally, the NRSRO shall be available to issuers' personnel and capable of reflecting issuer comments in ratings. Note, credit ratings based on security prices and spreads can be easily manipulated and provide profit opportunity to unscrupulous investors.

Regarding objections to H.R. 2990, below are rebuttals. H.R. 2990 does not disrupt the markets. Increased competition should improve market conditions. H.R. 2990 does not violate First Amendment. Additional competition should not affect First Amendment protections. H.R. 2990 does not promote rogue firms. Additional competition should encourage the issuance of timely, accurate ratings.

Moving forward on this issue is critical. We are all aware of the problems caused by the faulty ratings of WorldCom, Enron, and other failed issuers. However, less obvious are the problems caused by underrating firms, such as Nextel. As can be seen in the attachment, we rated Nextel at BBB-, as of November 2003, when S&P rated the company at BB-, and Moody's at only B2. The difference in cost between a BBB- rating and a B2 rating is approximately 300 basis points, or 3 percent. Nextel had $10 billion of debt at the end of 2003. The additional cost is $300 million per year of these faulty ratings, $300 million is the amount greater than the earnings of most public firms. By the way, both S&P and Moody's raised their rating to investment grade in August of 2005.

Thank you for your time and interest. Attached is additional information on Egan-Jones.

[The prepared statement of Sean Egan can be found on page 30 in the appendix.]

ChairmanOXLEY. Thank you, Mr. Egan, and thank all of you gentlemen for excellent presentations.

Let me begin with a few questions. One of the critiques that we have heard over the last few months regarding Congressman Fitzpatrick's legislation is there will be—this legislation would lead

to rating shopping, with the rogue firms jumping up and lowballing and the like, creating perhaps an artificially competitive marketplace. Are those criticisms justified, and let us just begin with Mr. Reynolds and go to my left to right.

Mr. REYNOLDS. Well, it is, excuse me, it is certainly not without past history. That was something that was done in the money market business in the '80s, where, with all due respect to some of the roll ups, the idea was if you couldn't get Moody's and S&P over from an A to a P to a 1 rating, you'd go shop at Fitch and Duff to get the Def One F1, so, you know, that is a pretty benign form of it. I think the way the reform is more likely to play out is you are going to have more companies entering the space using investor-based models, not issuer-based. Because right now, there is a stranglehold on the issuers, and, frankly, the issuers will have a very hard time going to smaller organizations that are just on the way up. So it is not going to be the issuer that drives the reform. It is bringing high information content, high quality ratings to investors, and they are certainly not looking for anything other than good input to manage their risks. So I think that is a real risk, but I would say that is the one in 10 piece of the equation. The nine in 10 is how do you build a revenue model, how do you build a firm of scale, and in order to do that, you are going to have to go to the investors, not the issuers.

Chairman OXLEY. Mr. Stevens.

Mr. STEVENS. For various purposes, mutual funds, as investors already have to do independent credit analysis. They can't simply rely on ratings. What we would like to see the legislation do, Mr. Chairman, is to provide much more information about the ratings agencies and their processes so that we can assess the quality of the ratings that they are producing. There is no incentive that I can see for a mutual fund investor to rely upon or to shop for bad, poorly produced ratings. Quite the contrary. But as institutional investors, if they have access to the information, they can make judgments about the quality of the ratings agency and what they are producing, and I think then, they will go to the strongest and best ratings to utilize in making their investment decisions.

Chairman OXLEY. Mr. Roberts.

Mr. ROBERTS. Well, I don't believe that there is that much risk with respect to the issue of ratings shopping. First of all, as Mr. Reynolds indicated, any organization has to worry about its reputational risk, and the marketplace should be able to discern pretty easily, through readily available performance benchmarks, if someone is systematically an easy grader. There are ample, verifiable statistical measures, such as default statistics and rating comparisons on issuers rated jointly by multiple agencies, which should reveal any such easy grader pretty quickly. In my judgment, this concern is probably already addressed in the marketplace, where market pricing mechanisms such as bond spreads routinely second guess the credit rating and would highlight firms that are consistently assigning higher ratings than would be warranted by an issuer's financial condition. So I would consider the risk fairly slight, certainly as compared to the benefits of competition.

Chairman OXLEY. Professor Macey.

Mr. MACEY. I agree with what Mr. Roberts just said. I would add to that that given the prominence of institutional investors in today's investing world, my inclination is that new entrants into the credit rating game are going to be extremely concerned about screwing up and giving a high rating to somebody that, like to a company, that later implodes and getting branded with the sort of moniker of being too easy. So I think the market will take care of itself, with the institutional investor community being able to sort out the new entrants that are providing valuable information and ignoring those that are engaged in the sort of race to the bottom that was just suggested. So I am not—I think it is—that we will see much better quality ratings, and we will see pressure that we don't observe now on firms to compete along the vector of quality.

Chairman OXLEY. Professor, if I could—let me digress just a minute because in your testimony— I have got to do this before I think of it; otherwise it is gone. That is just the way my mind works. I was in law school a long time ago, so I am trying to come back to this. But anyway, your testimony was regarding the accounting firms and the lack of competition now that we are down to the final four. I wonder if you could help us through that. How do we create an atmosphere in which we create more competition and get back to what used to be the Big Eight, or at least some semblance of that? How do we recreate that, or can we, and what are the prospects?

Mr. MACEY. Well, just to be clear, it is easy, in my view anyway, to explain why we have no competition or very little competition in accounting, and I want to make it clear also that according to the General Accounting Office, the level, the lack of competition is much worse than is suggested by the fact that there are only four accounting firms. Because if you look at the level of specialization in the accounting industry, so you have these accounting firms that are focusing on aerospace, or focusing on biotech, that, in fact, companies in those industries may really, as a practical matter, after the demise of Arthur Andersen, only have a couple of firms to choose from. So it is really bad.

Now the reason that we have this problem is very similar in many ways historically to the reasons we have this credit rating problem, which is it is, if you will forgive me for saying so, a little largely attributable to what has turned out to be misguided regulation by the SEC, the NRSRO designation, in this case. With the case of accounting firms, the problem is in order for an accounting firm to qualify to regulate a company, it has to be the earning, the income that the accounting firm makes from the audit business has to be a small percentage of the audit firm's overall revenue, which means that you have to be a giant accounting firm, like Arthur Andersen, to qualify to audit a firm like Enron because, otherwise, your billings to Enron will be too big of a percentage of your overall earnings.

My own view, based on empirical work in the accounting industry, which I would be thrilled to discuss with you, suggests that the way that we ought to get rid of that regulation, and we ought to allow little bitty accounting firms, smaller accounting firms, the non-Big Four, and I will add, you know, the drop-off after the Big Four is pretty steep, to get into the business of auditing big compa-

nies, bearing in mind that I think this percentage test for independence is meaningless. As we saw with Arthur Andersen, what really mattered from the standpoint of the independence of the auditing firm wasn't Arthur Andersen as a company; it was the audit engagement team that was actually doing the work, and there, you had this guy David Duncan, and he didn't do anything else but Enron, and he lived at Enron, and he basically took, acted in many ways like an Enron employee.

A statute you undoubtedly are aware of, the Sarbanes-Oxley Act, deals with that to some extent, with the auditor rotation provisions, and I would suggest as an add-on to that that we relax these independence restrictions so that we could open up competition in the accounting business for the largest U.S. companies, beyond just the final four accounting firms that remain.

ChairmanOXLEY. Thank you. Mr. Egan.

Mr.EGAN. I have to differ with the other panelists. We think it is a huge problem, and let me explain why. Approximately 90 percent of the revenues in the rating industry are generated by the issuers. People respond to the money, and there is no reason why you wouldn't have rogue firms emerging that are giving very generous ratings. It would be difficult to prevent that.

An extreme example would be, under the current Act, an underwriter can form a rating firm. It could be under the underwriter's name, Merrill Lynch Ratings, or it could be an affiliate of Merrill Lynch, and could say, ″Come to us. Don't worry about the ratings; we will take that. Yes, we will go to S&P and Moody's because they have been there forever. We will take care of the ratings. And by the way, there will be a fee for that.″ There is little that can prevent that under the current Act.

If you look at the business, there is about $6 billion in revenues. Over $5 billion of it is generated from issuer compensation. So I think the fear of the emergence of rogue firms is very real, and it makes sense to set up some protections against that. In my testimony, I used the analogy of trucking firms or drivers. The credit rating market is fundamentally different than the investment advisory field. You don't want drunk drivers on the road. You don't want inexperienced drivers on the road. It is too important. Why is it important? Because a lot of parts of the regulatory system rely on these ratings. I think you want to have some initial checks. If firms don't abide by it, like S&P and Moody's should have been put on some kind of probation as a result of the Enron, WorldCom ratings, and that didn't exist. There should be some kind of checking system, but before they even get on the road to issue these ratings, there should be some tests.

ChairmanOXLEY. Thank you. Mr. Reynolds, you indicated in your testimony that the bill needed definitional tweaking. What were you suggesting?

Mr.REYNOLDS. In particular, just the area between ratings and investment advisory work. It gets greyer by the day, and it is—for example, I mean, we are investment advisor. The fact that we would probably say buy, hold, or sell on some securities is an aspect that would make us want to do that, so we did that. With the rating agencies, they have always been very clear that they stop short of that, and there is quite a bit of a blurring here, not only

how they operate today, but also really how it is construed in the marketplace. It is the form versus substance debate. They have launched a product recently, for example, Moody's has, called market implied research strategies. They frame their ratings against where securities are trading, or where derivatives are pricing risk, and it is presented with, as a contrast. If they don't say buy, hold, or sell, but it is just about the same thing, it will take you right to the doorstep, and everyone sees it who uses that product for what it is, and there are other products like that as well. You know, you are the third base coach in baseball signaling the guy on first to steal second. You don't have to scream steal, you know; you just tip your hat. The rating agencies are doing the exact same thing. They are in the advisory business in substance, if not explicitly in form.

So one of the aspects of the bill that was a little murky for me around investment advisor versus NRSRO, and there are quite a bit of overlaps that people should be sensitive to, and it is just a little more drilled now in clarification of how companies typically operate. Everyone talks about default risk as the main issue. The great bulk of assets and risks that is managed out there, it is not about default risk. It is in terms of perception of default risk, but mostly, it is about short term, rapid changes in the risk that affect portfolio performance and the result and losses being realized. As this, you know, I know I am overdoing the sports metaphor, but the great bulk of the activity in the credit markets takes place between the 20 yard lines, not in the end zone. The end zone would be a default. Default risks are historically very low, but credit volatility historically can be very high, and that is where investors are harmed, because of short term, sudden changes that drive losses. And that is where that investment advisory and NRSRO designation starts to overlap, and that probably should be worked on a bit.

ChairmanOXLEY. Thank you. The gentleman from Louisiana.

Mr.BAKER. Thank you, Mr. Chairman.

I want to return to Mr. Egan and the response to the chairman relative to the potential for creation of rogue firms. It would seem from your comment that there should be some requirement that a firm must meet beyond registration in order to engage in the practice, which might be just a slightly different standard than what we have today, as opposed to a registration and a free market driven system, which would enable a participant to enter without necessarily establishing credentials. Am I understanding your objections correctly, or is there a slightly different view?

Mr.EGAN. Yes, there should be some credentials before someone enters. As it is currently written, anybody, my son, 10 years old, he can be issuing ratings and become a rating firm and—

Mr.BAKER. But do you think an issuer is going to pay your son a fee? I mean—

Mr.EGAN. No, he's not going to receive a fee, but that is an extreme example, but it could be something like Merrill Lynch, who wants to get as much market share as they possibly can underwriting, set up their own or another rating firm, you know, that is affiliate and facilitate the underwriting process.

Mr.BAKER. Well, I take your point, worthy of further examination, but it seems to take me back to the dark days of the invest-

ment banker analyst issues and how one prescribes a system that allows the two to simultaneously coexist, but provide disclosures to the ultimate users of information, or judges of risk, about how a particular decision is being made so that if there is a particular unusual relationship between Merrill Lynch Ratings and a Merrill Lynch issuer activity, that those disclosures would help, in some measure, address it. My concern is that if we go to a hard and fast standard of entry, we are replicating in just a little bit broader methodology that we have today. Today, we are calling it artwork. We don't know what one is, but when we see it hanging on the wall, we see you are a rating agency. We might want to describe the frame. We might want to describe the colors. We might want to have the artist's name checked off, but we are really just going to have a little bit broader mechanism than we have today. If we really go to some sort of undescribed set of standards that one must meet. Perhaps, your suggestion of some criteria of time in the market—

Mr.EGAN. I think that makes sense. I think money talks. I think a certain revenue base makes a lot of sense. I think that the fundamental problem that we have right now is that you have two firms that are really, and have exerted a lot of influence in this process. There are other firms that do qualify, that do issue credible ratings, and have not been able to get the NRSRO designation, for a variety of reasons. Unfortunately, the current regulators aren't willing to state what the problems are, why their applications haven't been approved or disapproved, or what even the status of the application is. Bringing it back to the driver analogy, you need to have some fundamental tests because it is too dangerous to the market to go from the current market structure right now to wide open whereby anybody is allowed to shoot any game they want to. You need some levels of credibility, and I think being in the market for a couple market cycles makes perfect sense, and having a minimal level of revenues from the activity makes a huge amount of sense. It also makes sense to exclude certain affiliated firms. It makes no sense for a bank to be allowed to generate their rating firm because it opens the system to abuse. It makes no sense for an underwriter to be allowed to set up a rating firm. So—

Mr.BAKER. I don't disagree. I am merely trying to bore down a little bit.

Mr.EGAN. Right.

Mr.BAKER. Get a better understanding as to your driver example and not letting your 10-year-old son drive. It would be just as advisable not to have an 80-year-old grandmother who no longer can see.

Mr.EGAN. Absolutely.

Mr.BAKER. Even though she has been driving for 50 years.

Mr.EGAN. Right.

Mr.BAKER. The consequences could be the same. But Mr. Stevens, you made a note in your testimony, the NRSROs should have some accountability for their ratings in order to provide them with an incentive to analyze information critically, and then I am not— I am just pointing out that you raised a very important issue. Then Mr. Roberts, in your testimony, you talk about output criteria should be the measurement that we use, for example, ability to an-

ticipate corporate demise ahead of the necessary deterioration of share price. Then, you go on talking about the qualities of the Type 2 agencies that mark-to-market using software models often paid for by the buy side, which have track records of issuing early warnings and objectivity, and then I wind up back at the professor, who states that you oppose the disclosure of the requirements of telling someone how you go about issuing your ratings. It seems across the three of you, we go for a need to have disclosure and accountability so that the market can look at a rating agency's set of performance standards, then we go to Mr. Roberts' output measurement criteria to say this is how we are going to look at you and, therefore, hold you accountable. What is wrong with some sort of generic disclosure? I understand proprietary business formula not being necessarily put on the street, but if I am going to be the end user of the rating to make a risk judgment, shouldn't I have some appropriate disclosure of how they go about doing it? Professor.

Mr.MACEY. Yeah, let me just say I agree with that, the generic disclosure, as long as there is not any proprietary information. With respect to the sort of—the problem of this rogue, or rating agencies popping up like mushrooms in the wake of the statute, I want to—it seems that—it is important to realize that if this statute were enacted, we would be in a much different world, in the sense that we would be—we would no longer be in the current situation where companies are only permitted to invest in a wide variety of circumstances under both Federal law and various State laws, particularly insurance laws, in companies that lack this NRSRO ratings, so that the vector along which these organizations would compete would be a vector of quality, and to be frank, I appreciate Mr. Egan's frankness in sort of engaging the discussion. I don't really, with all due respect, sort of buy the car analogy because if there is some underage driver, or unqualified driver, he poses a risk to other people on the road, so you have this sort of externality problem that makes sense to regulate. If I am—if I exhibit sufficiently bad judgment that I make an investment decision on the basis of a rating from a rating agency with a poor track record or that is one of these rogue ones that we are concerned about existing, I internalize that problem. It is not as though I am in the car running someone else over. This is, in the world that we are going to see in the wake of the statute, if it passes, and I hope it will, then the people who make bad judgments with respect to utilizing bad rating agency information are going to internalize those costs in a free market in exactly the same way they are going to internalize the cost of getting bad investment advice from a broker or something of that nature, and I think that the markets will do a very good job in sorting out the good ones from the bad ones.

Mr.BAKER. Mr. Chairman, I have just got one more follow up. Mr. Stevens, you mentioned the—holding the rating system accountable in some form or fashion. Do you share the view that has been described by Mr. Roberts, outcome analysis as an appropriate measure of enforcing accountability, or how would you view a system that would be appropriate to create that accountability?

Mr.STEVENS. Well, outcome analysis is important information to have in the market so that the people who are looking to use a par-

ticular rating agency or particular rating, have some sense of what the track record has been. When I referred to accountability in my testimony, it was really accountability of the nature that contemplated that if a ratings agency says here is my process, this is what I do, then they are to be held to do that. If, for example, they say we don't really simply rely upon publicly available information. We go and do research on the premises. We talk to the officials of the company. We kick the tires in other ways as well. And if they then produce a rating where they haven't done that, that they really were relying on a smaller universe of information, it seems to me they ought to be liable and accountable for having misrepresented their process.

This notion of proprietary methods, I think, is a little overstated, with all respect. We deal with this issue in disclosures all the time. Corporations that are seeking to raise money in the marketplace will talk about business systems, business activities, business methods. There is a line that you can draw between what is truly proprietary and what is informative, detailed disclosure—I wouldn't call it generic; that suggests boilerplate. It can go into greater detail that that. So I think that is a line that we can draw.

If I might, Mr. Chairman, just add one other thing to this question about the drunk driver, the point I am making is, from the perspective of an investor, if you can administer the breathalyzer, right, and you can determine whether the driver is drunk, you can make a decision about whether to pile into the vehicle or not, and that is the value of disclosure in the marketplace. I see no reason why, well, there have to be changes in the way in the SEC has written 2a-7; I see no reason why a mutual fund firm that offers a money fund and has its franchise and its reputation on the line is going to be attracted to a schlocky ratings agency. There is going to be a tremendous attraction for the ones with the best track record, the best methods, and the greatest reliability and integrity in the market because the reputation and the dollars, essentially, the wealth of the firm, is going to be on the line in that process.

Mr.BAKER. I take your point, and I only one I had entering into the new methodology and how we start it up is probably so critical because if we have missteps in the early days, it really makes recovery in the out years much more difficult. To put a personal experience in the discussion, yesterday, when we were flying in, we thought we had made it, and everything was fine, and we were going to get on the boarding door, and the pilot comes on and says he pulled up about 5 feet too far, and they are going to have to bring a tug out and push us backwards. If I had known my pilot was going to miss my boarding door by 5 feet, I probably would have elected another flight. You don't want to find that out at your arrival gate. You really want to know, did he run over the dog when he came to pick me up, or do you keep it on the highway. I think that is really the issue right now. I want to get to this outcome based analysis. That means you have a record. That means I can look at what you've been doing. The problem is from where we are now to how do we get there, and I am not yet fully conversant with the remedy that gets us past that, but I certainly want to go where each of the witnesses have indicated they would like to see us go.

I yield back, Mr. Chair.

Chairman OXLEY. The gentleman from Pennsylvania.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Mr. Reynolds, I appreciate your references to the history of the city and Constitution, and in your written testimony, you are referring to some of the players out there that wouldn't be interested in the success of H.R. 2990, specifically those who want a little less free speech, and what you say is as it stands now, Moody's and S&P seem to be saying Congress shall make no law respecting an establishment of competition to the NRSROs.

With respect to the NRSROs, can you describe how they may be using their protected status to get involved in other business lines, including some of those lines that your firm, CreditSights, is involved in?

Mr. REYNOLDS. They are probably coming as close to the line of being an investment advisory business as they have ever been, and partly, that is a response to building revenue. I have heard a lot today about different rules and regulations, but at the end of the day, it is about building revenue, whether you are at Moody's or you are at a startup, whether you are taking it from—we have been in business 5 years; we went from eight to a hundred people, and it is painstaking work, reinvestment, but you have to have a viable product, and someone writes you a check for it. If they write you a check for it, it is real, and if they are a sophisticated investor, you are getting warm. And the same thing for Moody's, when they want to continue to grow their top line, to drive their stock, and it certainly has done quite well, they have to find new ways to get out of the ratings areas, so they bought KMD; they have been buying content assets up. They recently bought a group of economists. They will continue to buy assets in because at the end of the day, they are a research firm, a ratings agency, but they are also in the content business, and they have to grow and leverage that fixed cost base. So they are pushing into a lot of different ancillary businesses, which are meaningful businesses, and how do you reach the equity, the stock analysts for example, with credit information?

As we saw in the last 5 years, turns in the credit market can drive the equity performance of different names, so they are trying to figure out ways to go after all different types of investors using their basic infrastructure and making select investments, so they are in the investment advisory business in substance. They know it. The market knows it, but they need to run a story line because they have to plan their legal defenses. They are doing everything but stopping short of saying sell, and they are doing that by trying to be also more relevant to the market. One of the criticisms, say, 10 years ago, was well, you are just a rater, there is low information value, and some of your earlier panelists in past hearings have testified on the low information content of ratings. So the way you crack the line up is you get into the information intensive business, something that a powerful institutional investor, or a bank, or a brokerage house will write you a check for. That is how you build a business. It is the economic reality of growth for all of these companies, and I think that Moody's and S&P clearly are getting that. KMD was obviously a big landmark transaction, getting into de-

fault risk analytics. They keep that separately housed. But they are into the consulting business, for example. They are into economic forecasting. They are into all the same things the Street has been into for years, except it is not as NASD framework. So that is just a fact; I mean, people know it. It is like an ill-kept secret from X rating agency, and they will say, they will chuckle about the First Amendment discussion because they know that it is really not the main issue. They just want to stay free clear of any encumbrances and go back to the business line strategy. There is a reason why a lot of people want to get in this business. Moody's has 55 percent profit margins. That is just mind-boggling of pretax margins. The accounting firms don't have that, so there is a reason people don't want to get in the accounting business, but do want to get in this business. And also, at the end of the day, they are not staying up late at night worrying about CreditSights, Rapid Ratings, or Egan-Jones. In a way, we are all boutiques in the context of what they do. They are worried about Thompson, Bloomberg, Fax, Bertelsmann, Morningstar; these are the guys who will be stepping in, so the more barriers you put for their entry and their acquisitive activities, the more it is that Moody's and S&P will be the same old duopoly 5 years from now. So be cognizant of the fact that it takes a lot of capital, a lot of resources, a lot of mergers, and a lot of activity the next 5 years to even mount a viable competitor against a group of people who have dominated the industry with what are increasingly higher natural barriers to entry. So I am a firm believer in letting the market work, and if Fidelity or Imgo or these top debt shops will pay you for your service, I think you have passed a test that the SEC is less qualified to opine on than people who live and breathe that business day in, day out, and have responsibility for a lot of retail assets. So I would say competition is better and quality is better. Constraints impact both in the wrong way.

Mr.FITZPATRICK. Do any of the other panelists want to comment on that? Professor Macey, I think you were—you have spoken about the First Amendment issues, as one of the NRSROs, I think it was S&P, it seems to be the loudest about the impact of this potential legislation on their First Amendment rights. You went right to the ledge of saying why you think they may be raising that issue. Do you want to expand on that at all?

Mr.MACEY. Well, as I said, with the exception of the provision that would prohibit unsolicited ratings, there is nothing in this that has the remotest impact on free speech. I think that, you know, if I were a paid consultant for S&P or Moody's, you know, I might play the First Amendment card because it gets people's attention. It slows the process down. And it seems to have been—it seems to be the case that the process slowed down quite a lot. Mr. Reynolds and I were—testified together before that Senate committee—I guess it was a couple of years, 2 or 3 years ago now—and we are still working toward some resolution of this issue. So, I mean, as I, you know, I don't think that there is a—I don't think there is a respectable argument. I think a lot of the things we have talked about today, Mr. Egan's point is perfectly respectable that, you know, this is a concern about, I don't happen to agree with it myself, but it is certainly a respectable argument to say you know, we

are worried about quality of the new entrants and the issues about disclosure that Mr. Stevens is raising quite—I may come out a slightly different place, but quite respectable. The First Amendment issue is, in the context of the development of the securities laws in the United States and the high premium that we put on disclosure and investment, investor protection, this is really—this doesn't even ruffle the waters in the pond with respect to First Amendment concerns. I think it is purely a tactic to impede the progress of legislation that would improve the competition in this industry.

Mr.FITZPATRICK. To that issue of, I guess, Mr. Egan's concerns about his 10-year-old son issuing rating, getting recognized. I mean, the statute, the bill as written does require 3 years background and does require disclosure of short term and long term performance statistics, so if you are in the business for 3 years, and there are benchmarks, and you are reaching those benchmarks, as Chairman Baker says, you know, if somebody is willing to pay your 10-year-old son, wouldn't it be discriminatory, if your son was only 10 years old and they—

Mr.BAKER. We have this freedom of speech, I think, is what you are talking about.

Mr.FITZPATRICK. If you are doing a great job, I mean, you wouldn't want to prohibit your 10-year-old son genius from being involved in this business.

Mr.EGAN. Maybe he can get it right. However, I think that this NRSRO designation is too important. It is used in too many different areas of financial markets, and I think more than 3 years is needed. I think you need some kind of market test, and a revenue based test isn't a reasonable way. I think you have to exclude some firms that have an inherent conflict, such as underwriters becoming rating firms, or having underwriting affiliates, or major investors, or banks, or insurance companies. I think that there are some—to go from where we are right now to a more competitive market, you have to be careful in the way you take those steps. It would be foolish to open it up to anybody who applies after a 3-year waiting period. It makes—that doesn't—it would hurt the market too much. It is too great a risk. Yes, it might work, but you know, it is—we are not talking about a small economy here. It is very important to get it right. Another thing is that somebody brought up the breathalyzer test. I don't know if the guy who I am facing on the road has taken that test when I am driving and he is driving at 80 miles; I don't have that information. So I want somebody to test him before he gets in the vehicle, and there are certain safeguards if he messes up that he loses his license. I think that that is what you need. Also, some people say don't worry, the market is going to sort it out. Well, the reality is that that is fantasy. It is fantasy because S&P and Moody's rated Enron at investment grade approximately 30 days before it went bankrupt. They had similar faults with WorldCom. So the market doesn't necessarily respond to good information. In fact, S&P and Moody's operating income has doubled. It has doubled over the past 3 years. You hear about it all the time in the economist book, but it doesn't work; full disclosure just simply doesn't work or else S&P and Moody's revenue and operating income would not have doubled

during the process of these major debacles. So you need some safeguards on the front end of this, and you also need safeguards as you go along.

Mr.FITZPATRICK. It looks like Professor Macey—do you want to respond to that?

Mr.MACEY. Well, I guess I will pay a visit from fantasy land over here, in terms of having faith in the markets. First, with respect to the point about Enron. Certainly, Mr. Egan is right. This was not a poster day for the credit rating agencies. It seems to me the question that we need to ask ourselves is not the question, you know, will there be errors, and will credit ratings agencies screw up under the new regulatory regime, the new statutory regime that we are talking about today. The question is will the quality of information in the marketplace be better, not will it be perfect. And certainly, I think one thing Mr. Egan and I would agree about is that the quality of the information that is out there now is, generated by the credit rating agencies, is not good. It is not good for two reasons. Number one, it tends not to be very accurate and, number two, the adjustments that are made to credit ratings come very slow, and they are—that every financial economist or empirical scholar who has looked at this for the last 30 years has understood that credit ratings systematically lag stock market prices and that anybody, for free, can look at stock market prices and get a much better view of what is going on at Enron, what is going on at WorldCom, what is going on in any of the companies that have been so much in the press over the last 3 or 4 years. If we open the system up to competition, certainly, there will be errors. Certainly, some of the new firms that emerge in this business will make mistakes, but on balance, consumers in this market will have a lot more to choose from. They don't have to rely on one rating. They can look at several, and the market will sort out the poor performers and, again, the people who are—make the misjudgment, the miscalculation, to rely on the bad ratings that emerge in a new competitive environment will bear the costs associated with that, which is exactly what ought to happen in a free market economy.

Mr.STEVENS. Mr. Fitzpatrick, may I add something in response to the questions that you had posed, just very briefly? The question of 3 years or 7 years is one of these classic conundrums I suspect that the committee, the Congress faces all the time. I think of it as the prunes issue. Are 3 too few; are 7 too many to get, you know, regularity restored? The fact is seven years strikes me as fine if you are part of a firm that has been doing this for the past 7 years, but it might be that you have a wonderful new market participant ready to enter, and if they are told well, no, you have to do this, theoretically, for 7 years before you can get into the business, that has a significant anticompetitive impact. So while, you know, this is sort of in the eye of the beholder, I think, some proving ground or time period, where you are involved, and can demonstrate to potential users that you are serious about this business, that you have been doing it with the kind of rigor and quality, is fine. Three years strikes me as a good choice in that regard. Seven years strikes me as not really trying to serve opening up this market to the kind of competition which I think has been your purpose and the purpose of other supporters of your legislation.

Chairman OXLEY. The gentleman yields back. On behalf of the members, I want to thank all of you for excellent participation. The record that we have continued to build for this legislation I think is extraordinary. We have had a diverse group of witnesses over a number of months, and this may or may not be the last hearing, but it certainly was one of the most productive, and I thank you, and I also want to thank the Federal District Court for providing this wonderful place for a hearing. This is as close as I am going to get to being a Federal judge.

Mr. FITZPATRICK. I hope it is as close as I get to a Federal judge.

Chairman OXLEY. That is right. I would like to sentence a couple people right now, but I don't have it in me. Again, thank you all, and the committee is adjourned.

[Whereupon, at 11:40 a.m., the committee was adjourned.]

A P P E N D I X

November 29, 2005

Egan-Jones Ratings Company
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Providing timely, accurate credit ratings to Institutional Investors

Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Company Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Nov. 29th Hearing – The Credit Rating Agency Duopoly Relief Act of 2005

We support the proposed legislation (HR 2990) for reforming the ratings industry since it significantly increases competition in the industry.

The primary purpose of rating firms is to facilitate the allocation of capital by assessing the relative riskiness of various issuers. The job can be compared to the trucking industry in the sense that capital rather than goods, are moved throughout the financial system. Unfortunately, the regulatory process for the trucking industry makes a great deal more sense than does the regulatory process for the rating industry. In the trucking industry, there are various tests drivers need to take to ensure that they are able to operate vehicles in a safe manner. The tests are straight-forward, and passing them is similar to passing a driving test. In the ratings industry, there has never been a formal process for obtaining a license, and at the current rate there never will be. Regulators had been studying the area since the early 1990's and have yet to establish a set of requirements for applicants. Yes, two firms in the past couple of years have been recognized, but for the most part, the firms provide little competition to the major firms in the industry. (DBRS rates mainly Canadian issuers and AM Best focuses on insurance firms.)

In the trucking industry, if a shipper is unhappy with the rates or service of one particular shipper, there are a variety of other shippers available. In contrast, in the ratings industry there is relatively little competition. S&P and Moody's garner approximately 85% of the revenues for US corporate debt, and a rating from two firms is normally needed for a public issue. The costs for the lack of competition is borne by issuers, investors, employees, retirees, and non-recognized rating firms.

To address some of the concerns that have been raised about H.R. 2990 facilitating the emergence of a plethora of unqualified rating firms, we recommend the following additions to Section 3(a):

Independence - No NRSRO shall be affiliated with a broker/dealer, bank, financial institution, issuer, investor or user of credit ratings.
Experience – the rating firm shall have issued ratings for the past seven years and shall have generated at least $1 million in revenues from such activities in the U.S. for a period of seven years or more.
Quality – to reflect the impact of events such as acquisitions, major share repurchases, and buyouts, all ratings issued will be reviewed using qualitative methods. Additionally, the NRSRO shall be available to issuers' personnel, and capable of reflecting issuer comments in ratings. Note, credit ratings based on security prices and spreads can easily be manipulated and provide profit opportunities to unscrupulous investors.

Regarding objections to HR 2990, below are rebuttals:

H.R. 2990 Does Not Disrupt Markets – increased competition should improve market conditions.
H.R. 2990 Does Not Violate First Amendment – additional competition should not effect First Amendment protection.
H.R. 2990 Does Not Promote Rogue Firms - additional competition should encourage the issuance of timely, accurate ratings.

Thank you for your time and interest. Attached is additional information on Egan-Jones.

Egan-Jones Ratings Company

Information on Egan-Jones Ratings Co.

We applied for the designation in July 1998 and have regularly issued timely, accurate ratings and provided warning for the Enron, Genuity, Global Crossing, and WorldCom failures (see the attachment). Furthermore, we consistently identify improving credits; most of our ratings have been higher than S&P's and Moody's over the past three years, thereby assisting issuers in obtaining more competitive capital. Our success has been recognized by the Federal Reserve Bank of Kansas City which compared all our ratings since inception in December 1995 to those of S&P and concluded:

> "Overall, it is robustly the case that S&P regrades from BBB- moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR."

New York Times
Gretchen Morgenson (Pulitzer Prize Winner) July 7, 2002
"Egan-Jones makes a practice of alerting investors to corporate credit problems well before they are acknowledged by management… As early as November 2000, for example, Egan-Jones cut its ratings on WorldCom to the lowest investment-grade level, citing its deteriorating profit margins and credit quality."

Fortune's "Against the Grain"
Herb Greenberg January 21, 2002
"The best balance-sheet snoops are often way ahead of the pack in finding signs of trouble. Sometimes, however, the big credit-rating firms, Standard & Poor's and Moody's, which get paid by the companies they rate, are slow off the mark--slower, as a rule, than independent bond-rating services like Egan-Jones.

Investment Dealers Digest (cover)
Dave Lindorff August 13, 2001
"It didn't take long for Sean Egan, managing director of Egan-Jones Ratings Co., a small ratings agency outside Philadelphia, to figure out last fall's California power crisis would eventually put the state's utilities in a bind. "We saw a train wreck ahead for these companies," recalls Egan, who says his analysts quickly fired off two reports to clients warning them of the troubles facing the state's two utilities-Pacific Gas & Electric Corp. and Edison International, the parent company of Southern California Edison. On Sept. 27, the firm lowered EIX's rating from A- to BBB-, and PG&E's rating from A to BBB+."

Bloomberg News
Mark Gilbert October 14, 2004
"S&P wouldn't be the first to pin a non-investment grade rating on Ford. Egan-Jones Ratings Co., a private company run by Sean Egan in Pennsylvania, cut the automaker's grade in January 2002."

Grant's Interest Rate Observer Annual Conference, October 2002
"The big two-and-a-half rating agencies have not exactly covered themselves in glory during the current credit debacles. Sean Egan, co-founder of Egan-Jones Ratings Co. (which saw many disasters coming before they landed in the newspapers), will discuss debacles and opportunities yet over the horizon."

Egan-Jones Ratings Co.
November 29, 2005
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NEXTEL's Senior Unsecured Ratings

The bold indicates investment grade

	Egan-Jones*	S&P	Moody's
07/16/2002	B+	B+	B3
08/29/2002	BB-	B+	B3
02/20/2003	BB	B+	B3
06/19/2003	BB+	B+	B3
7/21/2003	BB+	BB-	B3
7/22/2003	BB+	BB-	B2
11/26/2003	**BBB-**	BB-	B2
02/19/2004	**BBB**	BB-	B2
3/22/2004	**BBB**	BB+	B2
3/22/2004	**BBB**	BB+	B2
3/24/2004	**BBB**	BB+	B2
5/26/2004	**BBB**	BB+	B2
06/09/2004	**BBB**	BB+	B2
7/7/2004	**BBB**	BB+	Ba3
7/27/2005	**BBB+**	BB+	Ba3
8/10/2005	**BBB+**	BB+	**Baa2**
8/16/2005	**BBB+**	**A-**	**Baa2**

Enron's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's
4/19/2001	BBB+	BBB+	Baa1
→**6/27/2001**	**BBB**	BBB+	Baa1
8/15/2001	BBB/ BBB-	BBB+	Baa1
10/16/2001	BBB/ BBB-	BBB+	Baa1 (neg.)
10/23/2001	BBB-	BBB+	Baa1 (neg.)
10/24/2001	BBB-/ BB+	BBB+	Baa1 (neg.)
10/26/2001	**BB+**	BBB+	Baa1 (neg.)
10/29/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
10/31/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
11/1/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/6/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/7/2001	**BB-/ B-**	BBB (neg.)	Baa2 (neg.)
11/9/2001	**BB**	BBB- (neg.)	Baa3 (neg.)
11/21/2001	**BB/ BB-**	BBB- (neg.)	Baa3 (neg.)
11/26/2001	**BB-/ B+**	BBB- (neg.)	Baa3 (neg.)
11/28/2001	**B+/ B-**	**BBB- (neg.)**	**Baa3 (neg.)**
11/28/2001	**C/ D**	**B-**	**B2 (neg.)**
11/29/2001	**D**	**B-**	**B2 (neg.)**

11/30/2001	**D**	**CC (neg.)**	**B2 (neg.)**
12/3/2001	**D**	**D**	**Ca**

* Current and projected ratings

WorldCom's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's	Action
11/1/2000	A- (neg. watch)	A-	A3	EJR issued neg. watch (A-)
11/ 3/00	A- (neg. watch)	A- (neg. watch)	A3	S&P issued a neg. watch (A-)
11/17/2000	BBB+ (neg. watch)	A- (neg. watch)	A3	EJR cut A- to BBB+ (neg. watch)
2/8/2001	BBB	A- (neg. watch)	A3	EJR cut BBB+ to BBB
2/27/01	BBB	BBB+	A3	S&P cut A- to BBB+
6/25/2001	BBB-	BBB+	A3	EJR cut BBB to BBB-
7/26/2001	**BB+ (neg. watch)**	BBB+	A3	EJR cut BBB- to BB+ (neg watch)
1/29/2002	**BB (neg. watch)**	BBB+	A3	EJR cut BB+ to BB (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3	EJR cut BB to BB- (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3 (neg. watch)	Moody's issued a neg. watch (A3)
2/19/2002	**B+**	BBB+	A3 (neg. watch)	EJR cut BB- to B+
4/12/02	**B+**	BBB+ (neg. watch)	A3 (neg. watch)	S&P issued a neg. watch (BBB+)
4/22/02	**B+**	BBB	A3 (neg. watch)	S&P cut BBB+ to BBB
4/23/02	**B**	BBB	A3 (neg. watch)	EJR cut B+ to B
4/23/02	**B**	BBB	Baa2	Moody's cut A3 to Baa2
4/25/2002	**B-**	BBB	Baa2	EJR cut B to B-
5/ 9/02	**B-**	BBB	**Ba2**	Moody's cut Baa2 to Ba2
5/10/02	**B-**	**BB**	**Ba2**	S&P cut BBB to BB
6/14/2002	**B- (neg. watch)**	**BB**	**Ba2**	EJR issues neg. watch
6/17/02	**B- (neg. watch)**	**B+**	**Ba2**	S&P cut BB to B+
6/20/02	**CCC (neg. watch)**	**B+**	**Ba2**	EJR cut B- to CCC (neg. watch)
6/20/02	**CCC (neg. watch)**	**B+**	**B1**	Moody's cut Ba2 to B1
6/26/02	**D**	**B+**	**B1**	EJR cut CCC to D
6/26/02	**D**	**CCC-**	**B1**	S&P cut B+ to CCC-
6/26/02	**D**	**CCC-**	**Ca**	Moody's cut B1 to Ca
7/ 1/02	**D**	**CC**	**Ca**	S&P cut CCC- to CC
7/17/02	**D**	**D**	**Ca**	S&P cut CC to D

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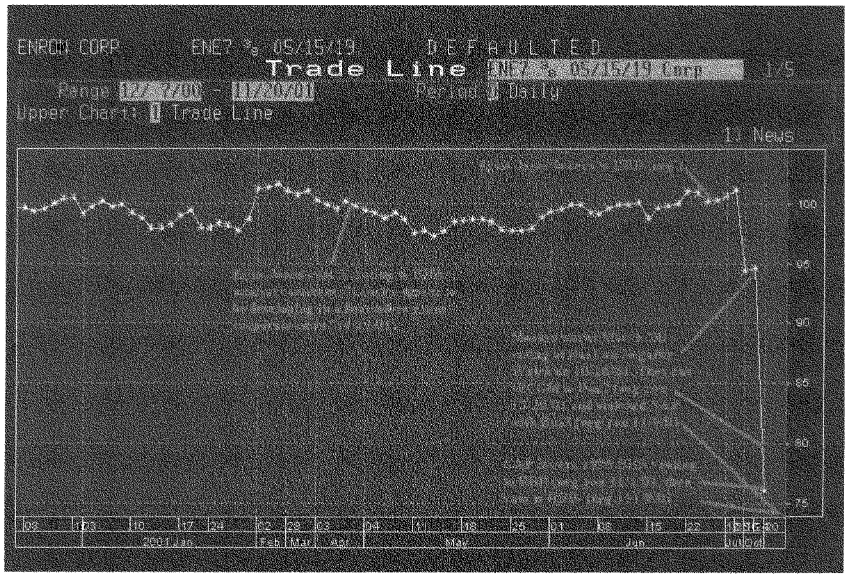

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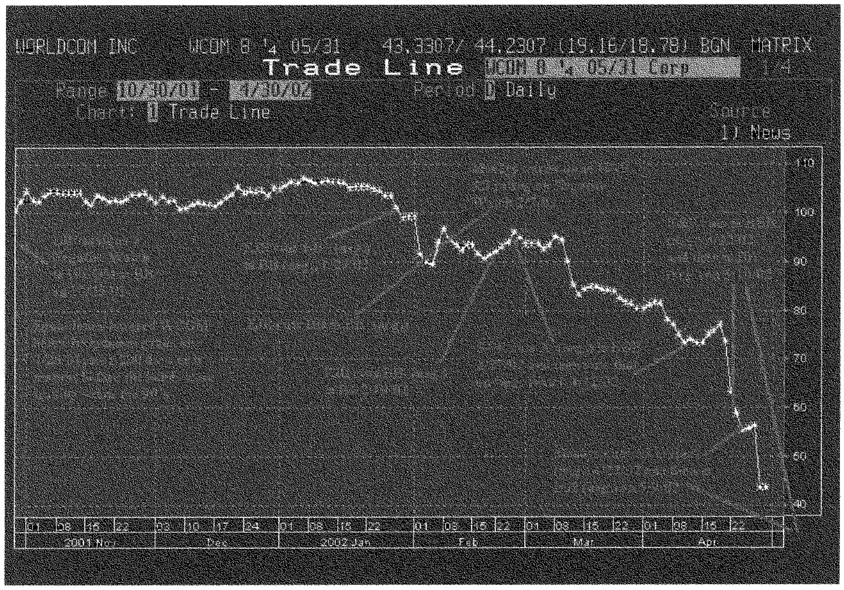

Testimony of
Jonathan R. Macey
Yale Law School

Before the House Committee on Financial Services

on

The Credit Rating Agency Duopoly Relief Act of 2005

I am the Sam Harris Professor of Corporate Law, Corporate Finance and Securities Law at Yale University. I am submitting this testimony in response to this Subcommittee's request that I discuss my views of H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005.

Let me begin by saying that I am pleased to be here and that I commend Congressman Michael G. Fitzpatrick for introducing this important and timely legislation. The statute he is proposing provides a valuable legislative framework that will foster more vigorous competition in the rating agency business, and provide not only better ratings but also provide strong protections for individual investors.

H.R. 2990 is based on the time-honored principle of disclosure and takes the SEC out of its current, ill-fated role as substantive regulator of credit rating agencies fortunate enough to be designated by the Commission staff as "NRSROs" The proposed legislation, which I support, would amend the eight federal statutes that contain the term NRSRO to replace the term currently used "recognized" with a new term "registered." The "Credit Rating Agency Duopoly Relief Act" was introduced in the House. The legislation is intended to enhance competition, transparency and accountability in the credit ratings market. The Act would eliminate Nationally <u>Recognized</u> Statistical Rating Organizations. The Act would require the SEC to rely upon Nationally <u>Registered</u> Statistical Rating Organizations. This change would eliminate the ambiguous process

of recognizing rating agencies through SEC staff no-action letters and would require all rating agencies that issue publicly available ratings to register.

Credit ratings play a major role in the securities market; investors rely on credit ratings when making investment choices. Credit rating agencies rate companies, countries, debt obligations such as bonds, asset-backed securities, commercial paper, private placements, certificates of deposits, and other securities, such as preferred stock, medium-term notes, and shelf registrations. The Credit Rating Agency Duopoly Relief Act of 2005 would eliminates the current, ambiguous designation "Nationally Recognized Statistical Rating Organization" (NRSRO) currently in use in favor of a more transparent registration process, that would enable market participants to register as "Nationally Registered Statistical Rating Organizations." This simple change will foster in a new era of meaningful competition in the credit ratings market.

The new legislation would replace the SEC's current anti-competitive designation process and prohibit anti-competitive industry practices. More controversially, in my view, the legislation would require reporting and recordkeeping requirements for registered firms and give inspection, examination and enforcement authority to the SEC.

It is bizarre, in my view that to receive the NRSRO rating from the SEC a company must be 'nationally recognized' or, their ratings must be widely used and generally accepted in the financial markets. I agree with Congressman Fitzpatrick that the current NRSRO designation creates an artificial barrier to entry that "has created a chicken-and-the-egg situation for non-NRSRO credit rating agencies trying to enter this industry, thus fostering a duopoly" and that the lack of competition in the credit rating industry has lowered the quality of ratings, inflated prices, stifled innovation and allowed anti-competitive industry practices and conflicts of interest to go unchecked."

My law professor colleague Frank Partnoy has observed that the credit rating agencies pose an interesting puzzle for those of us who study financial markets. On the one hand a great deal of evidence indicates that their product, information, is not particularly inaccurate and, to the extent that it is accurate, by the time it reaches investors it is so stale as to be useless to the investors for whose ostensible benefit it is produced. The credit rating agencies dismal performance in their work on Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom, and most recently General Motors and Ford suggest that credit rating agencies aren't doing the job that the public thinks they do. A plethora of academic studies showing that credit ratings changes lag the market support this intuition.

The best explanation for this puzzle of the credit rating agencies' simultaneously enjoying great success while providing no information of value to the investing public is that the SEC inadvertently created this problem regulation when it misguidedly invented NRSRO designation. This designation has, over time, caused an artificial demand for ratings, despite their lack of usefulness to investors. Thousands of regulations, like Rule 2a-7 of the Investment Company Act of 1940 limit the ability of regulate financial intermediaries and other financial institutions to invest in companies that lack NRSRO ratings.

The Credit Rating Agency Duopoly Relief Act of 2005 would eliminate the role of the SEC staff in designating credit rating agencies as nationally recognized statistical rating organizations (NRSROs). This is a role that they never should have had in the first place.

The proposed legislation has many features that I support and some that I do not. I fully support the proposal to prohibit tying, which means forcing rated companies to purchase other services; and notching, which means lowering the ratings on asset-backed securities unless a substantial portion of the assets making up those securities are also rated by the agency. The

Credit Rating Agency Duopoly Act of 2005 would also direct the SEC to develop other reporting requirements and recordkeeping as it deems appropriate in the interest of investors and require registered credit rating agencies to have systematic procedures in place to manage conflicts of interest and prevent the misuse of non-public information. I support these aspects of the proposed legislation.

On the other hand, while I agree that, in the current regulatory environment, the giant credit rating agencies like Moody's Standard & Poor's should not be able to issue unsolicited (free) ratings. On the other hand, I see no problem in having credit rating agencies do this in the new, unregulated environment envisioned in this bill. I do think that there are problems with unsolicited ratings, however. In particular, there is the concern that rating agencies engage in "shake downs" of companies and municipalities in the market for credit. Do rating agencies demand payment by companies and municipalities for ratings? Is it true that, if ratings aren't bought, an unfavorable unsolicited rating may be issued as retribution and warning to others? Criminal sanctions should attach to such conduct, in my view. Rating agencies should be required to disclose when the ratings they are issuing are unsolicited. They also should be required to disclose whether they offered their services on a fee basis to the entity being rated but were declined. Finally, rating agencies should be required to disclose whether the information on which they are basing an unsolicited rating is as complete as the information they ordinarily possess when generating solicited ratings.

The proposed regulation would require that Statistical Rating Organizations disclose: (A) the conflicts of interest they face; (B) the procedures and methodologies used in determining ratings; (C) their ratings performance as reflected in statistical data showing their performance over short-term and long-term periods; and (D) the procedures they put in place to prevent the

misuse of non-public information. I support the disclosure of conflicts of interest (A), as well as the disclosure of ratings performance measurement (C), and procedures to prevent the mis-use of inside information (D). However, I oppose the requirement (B) that credit rating agencies disclose the procedures and methodologies that they use in determining ratings. I view this sort of information as being in the nature of proprietary trade secrets, which would be of great interest to rivals of rating agencies in what will, hopefully, be a competitive environment.

In general, however, I view H.R. 2990 as an important statute that will improve the quality of the information provided by credit rating agencies, and establish rating agencies as an important component in the U.S. system of corporate governance and investor protection.

Statement of Glenn L. Reynolds
Chief Executive Officer
CreditSights, Inc.

Testimony Submitted To
The Committee on Financial Services
United States House of Representatives
Hearing on the Credit Rating Agency Duopoly Relief Act of 2005
November 29, 2005

CreditSights welcomes the opportunity to comment to H.R. 2990, "The Credit Rating Agency Duopoly Relief Act of 2005." HR 2990 marks the first real action plan we have seen to inject some competition into a sector that has badly needed some innovation and some new market entrants for some time. As such, we fully support the legislation and expect that it will serve as a catalyst for constructive change in the credit ratings industry by promoting competition and bringing more intellectual and financial capital to the space. The legislation will serve the interests of the market by eliminating a major regulatory deterrent that has discouraged market entrants and investors.

As a growing provider of various credit research and analytical services selling to many of the same customers that use credit ratings services, CreditSights has in the past had the opportunity to provide input into the review of the NRSRO framework. While critical of how the agencies have performed and used their special rights and privileges as an NRSRO, we still endorsed the concept of the NRSRO in our March 20, 2002 testimony before the Senate and again as part of the SEC Hearing on the Ratings Agencies on November 15, 2002. Our endorsement of the NRSRO concept in those hearings was more a reflection of the critical role that such ratings providers play in the capital markets, and the need for a regulatory "bar" to clear for such agencies given their extremely important function. In endorsing the NRSRO concept, we had also clearly stated that the agencies were in need of some increased regulatory oversight that the current system did not provide. Both aspects of our view reflected their role in the markets. Our support of HR 2990 is consistent with our earlier testimony on NRSROs.

HR 2990 provides an elegant solution to the stalemate that has come out of almost four years of debate by offering to immediately lower barriers with a variation of the NRSRO concept with its approach of using the "R" as a "registration" system. In earlier testimony, we also noted that we had never applied for NRSRO status and had no plans to do so any time soon. From the standpoint of CreditSights, the cost and effort involved was not worth it for our firm given the track record of companies seeking to enter the NRSRO space. HR 2990 is likely to encourage more companies to enter into the fray of building larger scale ratings organizations.

Our own experience is not atypical for growing credit research firms as we look to gain a foothold in the independent credit research space. While we do compete with some of the NRSROs in providing alphanumeric ratings through our statistical default risk model, our main business line is not "ratings." That was as much a necessity to achieve growth as it was a strategic need since the current system frustrates expansion in the ratings business. Our main business line will remain providing information-intensive credit research, data products and default risk models more consistent with that of a registered investment advisor. We only provide "ratings services" as defined in HR 2990 through our statistical product offerings. We also compete in a limited context with Moody's and S&P in nonratings areas, where we see both rating agencies continuing to expand.

We have watched with increasing interest that Moody's and S&P have both expanded in what we would traditionally view as the capital markets debt research business and which in our view historically would clearly fall under either SEC or NASD regulation. We do not view regulation under either framework as particularly onerous and in fact just a normal cost and basic

responsibility of doing business. Unlike the rating agencies, our employees have grown up in regulatory environments at their prior employers (NASD, FSA, SEC), and CreditSights in its current form now falls under the regulatory purview of the SEC and FSA. That fact has never encumbered our independence, our ability to exercise our First Amendment rights, or constrained our ability to apply a range of methodologies in our research.

For any start-up, offering ratings products is a daunting challenge given the natural commercial barriers piled on top of the artificial barriers. We thus have focused our business-building efforts on research services provided to institutional investors, banks, and intermediaries since the barriers to the NRSRO status were absolutely insurmountable for any start-up. The only way to build any meaningful, independent research effort was to focus on "high information content" products and go to the key users of the such information—namely, the institutional investor base that uses these services and not the issuers that have become the regulatory captives of Moody's and S&P. We have built our base of clients to over 600 major institutional investors, but still view the enormous market power of the rating agencies with some trepidation given their inherent advantages to package services with their ratings offerings and use their considerable NRSRO-based market power to expand their client base in non-ratings services. Opening up avenues for more non-NRSROs to compete across a more diversified set of product offerings—including ratings—is consistent with opening up the market to competition in coming years.

HR 2990 Will Foster Competition and Let the Market Decide

If enacted, HR 2990 could change the competitive balance for many growing firms as well as provide the impetus for expansion strategies by leading providers of financial media and data-based products. We do not see HR 2990 as in any way "disruptive" to the capital markets. It may in fact be disruptive to the concentrated market power and entrenched position of Moody's and S&P if major content aggregators use the opening to roll up more of the small and midsized companies to take on the global scale of the duopolists in this high margin and growing business line. Users of credit ratings services will not be unduly burdened by changing the meaning of the "R" in NRSRO ("R" would now stand for registered). Much of the debate will not even show up on their radar screens, so it is hardly a major disruption. For investors, there may be some routine adjustments to make in language in prospectuses and regulated enterprises might have some paperwork to do, but they always have routine adjustments in keeping their primary constituencies (shareholders, policyholders, etc.) informed.

Anointing more ratings agencies with the "revised" NRSRO status will just follow a path already well blazed by the major debt underwriters for decades. Basically, once there were fewer. Now there are more. Educated players in the market can choose who they will deal with. As a frame of reference, the rise of the commercial banks and non-US banks in underwriting debt has not threatened the market. It has provided choice for consumers, brought innovation, and injected more financial and human resources. It had also heightened competition, raised the costs of personnel, pressured pricing, and tightened margins. New market entrants in the NRSRO space will raise more capital to expand, more professionals will seek employment, and larger entities will "buy" and "build" their way in. In fact, there will be job creation and human resource migration from other disciplines that may be shrinking (commercial banking, sell-side research, etc.). The issuers and the investor base will have more options and pricing will come under pressure and growth will need to be shared. That is the crux of the matter for Moody's and S&P. In the end, once Moody's and S&P get past this debate and the changes are enacted, they will just go back to making massive amounts of money and profitably growing their businesses.

As somewhat of a parallel example, we would remind the Committee how vigorously the securities industry opposed the entry of the commercial banks into their underwriting businesses. The reasons to keep the banks out were well documented and well lobbied. We would point out now how many of the same executives from the securities industry later were happy to go work for the commercial and non-US banks that ended up entering the brokerage business (usually for considerably more pay) after the banks entered the space and subsequently prospered. In the end, there was considerable innovation that came with the new competition, greater liquidity in

the marketplace, a wave of new product introductions, and strengthening of the US financial system. Along the way came wave after wave of rated products that enriched Moody's and S&P, who faced no such competition and pressure to innovate. We would expect a similar dynamic to be seen in the NRSRO space if competition is allowed and barriers to entry come down. There will be capital inflows, mergers, migration of hungrier personnel from the incumbents looking to take leadership roles, and more competition. There will be movement of experienced personnel from the Street as the more entrepreneurial-minded look to help growing firms eat into the NRSRO franchise and take equity in growing enterprises. Basically, all the competitive instincts that make the US the leading market in financial services are there to be tapped, and the NRSRO incumbents are looking to keep those instincts at bay.

In our earlier endorsement of some form of NRSRO framework, we nonetheless had highlighted that the approach to anointing new NRSROs was inefficient and no longer reflected the needs of a rapidly evolving marketplace where the lines between "ratings," "research services," and "data and analytics" products were all blurring and doing so across a global marketplace. We would highlight that Moody's and S&P have certainly taken full advantage of that blurring to rapidly expand the array of information and data services they provide. They of course have expanded into new areas from the protected beachhead of an anachronistic, ill-defined regulatory framework that gives them inherent advantages against any competitor that would look to offer service in competition with these two financial Goliaths. We also noted that the lack of competition and the limitations of the issuer-based model were undermining the quality of the products and services delivered into the market by making the revenue stream more tied to regulatory fiat than consumer (and investor) choice.

The rules (or lack of rules) as they are currently in place also have failed to police conflicts of interests that could be inherent in offering an array of non-ratings services to entities that the agencies also rate. The market has been down that path before with the audit and consulting functions of the relatively more regulated accounting firms, but it is an issue that has never generated much interest on the regulatory front in the context of the NRSROs. While we do not expect those issues of conflicts to be ever be formally regulated, we would expect that competition will be fostered by allowing market players in the area of general capital markets research or data services to enter the credit ratings space—just as Moody's and S&P enter these other areas more aggressively. Healthy competition and entrepreneurial innovation will only benefit from leveling this playing field.

Market Conditions Are Ripe for New Market Entrants

It is a fact of life that the incumbent rating agencies have created a de facto duopoly over the past three decades despite the combination of all the second tier ratings players into #3 Fitch. That market reality is not going to change unless the barriers are lowered soon. In fact, even more damage will be done and the natural commercial barriers will be raised even higher the longer the current artificial constraints are kept in place. There are sweeping changes that have been taking place the last several years that are creating exciting new market opportunities for entrepreneurial start-ups, for financial media firms, for providers of data and analytics, and for providers of private equity capital. These changes are partially rooted in advances in technology and low cost delivery of content via the internet, but the changes are even more tied to the dynamics of the post-Enron, post-WorldCom market backdrop and how that has altered the risk-reward for the banks and securities firms that were the traditional providers of institutional debt research.

In terms of the expansion of new markets, the increased use of securitization, the evolution of the Basel regulatory framework, the development of more regional capital markets in both developed and emerging markets, the steady growth of issuers and continued disintermediation of the commercial banks, and the rise of the credit derivatives markets all create opportunities for new products, more volume, and more expansion. The incumbent NRSROs would obviously prefer to carve those opportunities up among themselves. We don't blame them. Those opportunities will attract new capital and market entrants if the barriers are lowered. Letting the entrenched have

too much of an influence in shaping the lowering of barriers is questionable, since they will push for delay and higher barriers.

The market backdrop is creating both risks and opportunities for the market. The risk is that the breadth and volume of credit research is suffering on Wall Street after the "Enron and WorldCom years," and the opportunity is that the trend has provided room for new businesses to be created that offer research and information services that are independent and unbundled from "the Street." Traditional providers of market-based credit research services were usually housed at the investment banks, commercial banks, and brokerage houses, but we have seen a clear retrenchment of research services based on concerns over conflicts of interest, liability, and cost. The largest commercial bank and one of the largest bulge bracket debt firms in fact recently made the decision to stop publishing corporate bond research, and that has been mirrored in part at other major banks and brokerage houses both in the U.S and the EU. It is no coincidence that both Moody's and S&P are expanding in capital markets research areas and serving that same client base, and that in many respects they see it as a logical extension of the ratings services they have provided. They are standing on the line of being in the "buy-sell-or-hold" debt research business typical of an investment advisor without (yet) quite crossing it.

The same "walking the line" approach has always been true of the ratings services they have provided, where they stood on the line of being an integral part of the underwriting process of Wall Street while representing themselves to be mere publishing operations. The NRSROs are in substance in a role that is an extension of the underwriting business while exempt from expert liability under the 1933 Act and all the while waving the First Amendment flag. It is a masterful stroke of genius and brings high margins and low contingent liability risks, but it is one that has outlived credibility. While everyone else that comes close to those same lines is subject to regulation by any combination of the NASD, SEC, or FSA among others, Moody's and S&P would like to skate by as the New York Times and Wall Street Journal of credit quality. HR 2990 will allow more companies to enter the space who will see their role exactly for what it is. They will be providers of market-based research very much akin to what the sell side has been providing for years and subject to regulation. We expect the regulation to be very light-handed compared to anything the typical Wall Street analyst is routinely accustomed to.

Below we look at some of the questions that seem to be recurring in the debate around HR 2990. From our standpoint, the questions come down to support of competition or just more of the same delays. HR 2990 is a great start in allowing some real action to take place and a lot less dialogue that always ends in the same place, with the NRSROs and some of their allies frustrating change and thwarting competition even as they speak of how they welcome more market entrants.

Does HR 2990 promote competition?
Yes. It is clear that streamlining the process for the entry of new, credible and viable providers of credit ratings services will attract new ratings organizations from the current population of competitors both in the US markets as well as from Europe and the Asia-Pacific who are looking to establish a global footprint to rate issuers across multiple currencies. The much-discussed chicken-and-egg debate around "nationally recognized" should be put to a market test and move beyond the batteries of lawyers and interest groups that continue to weigh in. There is nothing more consistent with the principle of free, competitive markets than lowering barriers and allowing for new market entrants to bring innovative, high quality products to potential customers. Issuers will have more choices as will investors and consumers of credit risk assessment products and services. In the end, the regulators should let the market decide. If a major institutional investor writes a check to a research company or rating agency, and then keeps renewing, that ratings provider and research service should be deemed credible. Backroom negotiating, expensive lawyers, and good lobbyists should not be the swing factor.

Does HR 2990 protect investor interests in still holding NRSROs up to a set of standards?
Yes. We do not see S&P and Moody's as disagreeing that the historical NRSRO designation underscores that their role was a very important one, and some function was to be played by the

regulators in setting a bar for providers of ratings services to protect the safety and soundness of markets. The fact that their status was derived from a no-action letter and essentially constituted "zero regulation" apart from the benefits of special status (including exemption from liability and exemption from Reg FD) only made their regulatory deal even sweeter—and more profitable. HR 2990's "registration" system still provides a special status in many regards. The main challenge for aspiring ratings firms does not change. They still need to have institutional investors and/or issuers accept them and in many cases include their specific firm names in investment parameters. That is no small challenge and will only be possible if they bring more to the table in terms of product, information value, experience, and client service.

Is the time opportune for immediate movement given developments in the markets?
Yes. We suspect that the duopolists would like to hold onto their three-decade NRSRO head start a bit longer, and for Moody's its century of brand-building would seem like it does not need much more of a structural advantage provided by the regulators. Moody's and S&P certainly see what others are seeing in the market, namely, that the market has never been so ripe for rapid change in terms of how research and data services are delivered and that there are revenue opportunities in all of this change. Credit ratings services will be swept up in that pace of change also, but it is the new growth markets in research services and data and in rapidly growing markets that will compound the revenue growth above and beyond the usual expansion being witnessed on traditional ratings products. Profit and growth attracts competition, but for reasons now all too well known the NRSRO sector has not seen much competition.

Will the three-year rule limit the growth of new NRSROs and limit the growth of independent credit research?
No. The distinction between ratings services and nonrating services and how that flows into the registration process is an aspect of the bill that could use some clarification, but the bill refers to companies whose primary business is "ratings." It does not call for raising the barriers for new research firms, but calls for opening up the NRSRO playing field. The 3-year time constraint is understandable, but we would also point out that many companies could be potentially credible and significant players in the ratings market where "ratings services" have not been either their primary source of business for three years or where they could offer a viable product in 1 or 2 years.

We also would recommend caution around the timeline game played by the incumbent NRSROs. A classic ploy of the incumbent rating agencies is to request that the firms show they have a lengthy track record in default histories. In other words, the angle is "wait 10 or 20 years" before they can enter. We would highlight that many firms bring myriad skills to the table in various aspects of risk (estimating loss exposure on assets, assessing structural risks, specialized industry expertise that can be used in assessing issuer risks, security-specific knowledge such as with asset backed securities, regulatory expertise, accounting knowledge, etc.) which all play a role in how consumers of ratings and research products use ratings services. To use a sports metaphor, *default* is the ultimate risk and constitutes the "goal line" in credit research. That said, much of the action takes place between the 20-yard lines. For investors, securities price volatility and rapid changes in credit risk—though short of default—can be the more frequent risk variable that impacts performance and portfolio risk management.

We have some other concerns about the 3-year rule. The development of a less concentrated credit ratings market needs capital and global reach to make a significant impact against the market concentration of Moody's and S&P, and the mix of boutiques and modestly sized operators below the three leading NRSROs will need to experience a mix of M&A-driven expansion and possibly strategic and financial partners to reach the requisite scale. The three-year rule presumably will not interfere with that process and we also assume the SEC will have the latitude to use discretion in registering companies that may "buy" into the space rather than build. In one fell swoop one of the large financial media companies could make a meaningful dent in this business. It is unclear how that 3-year rule flows into any such inroads as part of diversification move by any such large well-capitalized players unless they acquire companies

meeting the criteria. We would note that all of the incumbent NRSROs are busy buying up "content" assets outside the traditional ratings services areas. Other major players operating in those areas should be afforded the same opportunity with respect to the ratings business. It would only serve the interests of building competition.

In addition, one of the objections to the bill from one trade group included the concern that providers of more traditional credit research ("buy, sell, hold") and investment recommendations would need to seek registration under the new act. While this is an issue worth clarification and could have an impact on CreditSights as a provider of such research, we currently view ourselves as registered investment adviser regulated by the SEC in the US and by the FSA in the U.K. We are accustomed to regulation in the securities markets and credit markets in particular. In fact, we have always been more surprised at how little regulation such major market forces as the NRSROs are actually subjected to. We see the SEC as playing a role that encourages the development of independent research platforms as well as more competition in the NRSRO sector and we expect more supportive than intrusive behavior on their part. Certainly the findings from the SEC hearings on NRSROs appeared to approach the topic in that fashion. In the end, debt research has not been an area very high on the SEC's priority list and one which traditionally had been an NASD issue. That will change as the market evolves and more research is unbundled from the street.

Will an activist role by the SEC discourage new market entrants into the ratings process and extend to general providers of credit research services?
It should not be the case. The SEC has done extensive work in the areas through its NRSRO review and can clearly determine the distinction between a provider of ratings services and a provider of independent research under its registered investment advisor framework. At the very least, HR 2990 relieves the SEC of the 4-year wrestling match it has been in as to whether it should take on the costly and time-consuming challenge of developing a rigid set of criteria that would determine the next round of NRSROs. The delay had been perplexing, but not for those who watched the incumbent NRSROs trying to frustrate and delay that process the way they are looking to derail HR 2990. In the end, the SEC asked for Congressional authority. They may not have expected HR 2990, but now they can take prompt action once it is passed. In a booming securities market, time is money for the NRSROs. The more time it takes for change and reform, the more money they make. All the while, they keep on pushing into more nonratings businesses.

Will HR 2990 be a catalyst for the building of viable competitors?
Yes. One of the major risk factors for any start-up, any strategic operating company, or any financial buyer looking to expand in this growing sector is the significant regulatory uncertainty that the jaded history of the NRSRO process has to inspire. To the extent that the bill lowers the level of confusion in the market, we will see more investment capital flowing into the sector, more strategic acquirers of assets entering the space as expansion moves or as part of an extension of existing business lines (media, data, analytics, etc.). We will also see more cross-border M&A activity by non-US firms, and the growth of bond markets where banks traditionally dominated will fuel interest in the business. For example, Japan, India and China have all witnessed a mix of mature players and start-ups expanding in the ratings business.

There is every reason to expect a lot of interest in entering the credit ratings market. According to Economics 101, high profits, high margins, high growth, and high prices in an industry attract market entrants. The fact that there have been virtually no meaningful market entrants—and in fact a considerable level of consolidation among the NRSRO incumbents and aspiring ratings firms, has all been well covered in prior hearings in Congress as well as at the SEC. The performance of the lead players certainly should attract attention. The financial performance of Moody's as the one NRSRO pure play in the market has been nothing short of extraordinary. Since mid-1998, when what later became Moody's was split off to trade largely on its own fundamentals, the total return on Moody's stock has been 427% vs. only 25% for the S&P 500 and 54% for the S&P 500 Financial Index. McGraw Hill (S&P's parent company) has returned 195% over that same time span. McGraw-Hill's lucrative financial business is housed within a

more mature and lower margin pool of other businesses, so it underperformed Moody's but still crushed the overall market.

Since the March 2002 Senate Hearings and the start of what has been a multi-year review by Congress, the SEC, and various agencies and political entities around the world, Moody's has returned 209% and McGraw Hill 70% vs. 18% for the S&P 500 and 30% for the S&P 500 Financial Index. It is safe to say that the fear of impending regulatory doom has not discouraged the market view of Moody's or S&P's risks. To break it down into time segments, Moody's stock has returned considerably more after the "threat" of regulation in the post-Enron/post-WorldCom environment than before. That is simply because the opportunities in the market have never been greater, global growth in a range of security classes has never been so attractive, and Moody's and S&P can still execute on global expansion in new regions, new products, and new non-ratings services from the staging platform of protected NRSROs. That protected status raises risks for potential market entrants including well-capitalized content aggregators that could be looking for horizontal expansion opportunities. It is hard enough competing against entrenched financial behemoths with inherent commercial advantages (client base, brand power, enormous financial flexibility) without keeping the behemoths on regulatory steroids.

The success of Moody's and McGraw-Hill against this backdrop is hardly a major surprise. The growth prospects for them remain compelling, and they have been able to counter and stall the lowering of barriers with considerable skill. What is most stunning is that such a favorable backdrop has not brought more concerted attempts to enter the space. That is something for the Committee to ponder as they look to institute reform. The lack of new NRSROs has to be clearly laid at the feet of the traditional regulatory framework, and there needs to be rapid change if the policy goal is to promote competition and rid the market of entrenched barriers. The four years since Enron have blown by rather quickly, and there have been a lot of hearings and a lot of testimony filed here and filed there. Some action is long overdue to get the real process of fostering competition on track and out of the discussion stages. The regulatory regime itself can be evolutionary just like virtually all other regulation, and the regulatory fear-mongering by the rating agencies is starting to get very repetitive.

Does HR 2990 constitute intrusive, "Big Government" regulation?

No. Anti-regulation sentiment is hardly new, but the benefits to the market that accrue from intensified competition are also hardly new. To espouse competition while at the same being against regulation is also not unusual, but the incumbent NRSROs have a unique twist. After all, it is regulation that has created the virtually insurmountable barriers they benefit from and impaired competition. HR 2990 corrects that flaw without getting intrusive.

The tone of the criticism of HR 2990 from various quarters is somewhat inconsistent on the "intrusive" theme. It seems to take on the combined attack of the bill doing too much but also too little. HR 2990 is called intrusive by the rating agencies themselves, but the bill is also accused of leaving too many questions unanswered. It appears to be the "you hit him high and I will hit him low" approach to attacking a bill. The bill itself is brief and is a call for simple action to open up the playing field. That is hardly intrusive. New ratings firms that register and cannot build a client base will quickly become "registered non-factors." The bill does leave unanswered questions, but the SEC is charged with continuing the process of sorting out the key variables as they follow up on their earlier work. To the extent HR 2990 made any such attempt to address all the possible questions in a legislative package, then it would in fact be intrusive and overbearing micromanagement of the free market. HR 2990 is not intrusive at all, and rather light in terms of the regulatory framework compared to what the traditional providers of credit research—the securities firms and banks—routinely face as part of the underwriting and trading process.

It is unlikely that any single legislative or regulatory initiative will come close to perfectly addressing all the needs of the credit markets and consumers of risk ratings products, and the market certainly can deal with evolutionary, light-handed regulation. What most segments of the "financial research" markets are not accustomed to is no regulation at all. Zero regulation (apart

from the huge benefits they are provided by the existing framework) appears to be the clear goal of Moody's and S&P in the areas of ratings services.

Practitioners of widely disseminated credit research in the securities markets are usually under the NASD or FSA framework, which is quite extensive but has never encroached on their ability to freely voice their views. Buy-side credit analysts seldom publish opinions for external dissemination, but they also are governed by a wide range of regulatory constraints tied to the type of portfolios they service from insurance to pension to mutual funds. Somehow the market is expected to believe that the NRSROs—one of the most powerful constituencies in the money market, debt and equity-linked capital markets and increasingly in the bank debt markets—should escape all regulatory oversight in stark contrast to the well traveled path of regulatory evolution we have seen in the brokerage, banking, and asset management industries. We can appreciate their attempt for what it is, but it is time for responsible governing bodies to take some action. HR 2990 is a great start.

Will HR 2990 help address the quality vs. quantity debate?
Yes. The quality vs. quantity decision is one best left to the marketplace and HR 2990 is firmly in that camp. If a company does not have a viable product, customers will not pay for it, investors will not listen to it, a revenue stream will not be generated, and that ratings or research service will not be a factor. Such offerings will be relegated to being just a voice (however loud) on the periphery of the market. We would assume the lack of a client base would lead to the provider not even being designated under the NRSRO system HR 2990 proposes. The track record requirements and proof of demand would seem to be a low hurdle to clear for a high quality product. If investor and intermediaries pay a company for its product, then that would appear to pass the quality requirement in the eyes of the market. Once again, let the market decide.

The market is quite capable of selecting across competing services. Just as investors can select their brokerage houses and underwriters they choose to do business with, why would investors not be afforded the same opportunity in providers of ratings and research services? We do not see any agency or legislative body better able to make the selection process transparent than investors parting with their hard-earned cash to pay for a service. Freedom of choice also promotes a focus on quality and innovation. That is hardly news, but it just has not been applied to NRSROs. Institutional investors have ample incentive to be cautious in their selection process. After all, they face myriad regulations and laws which govern the behavior of investors and underwriters around prudent investment practices, fiduciary responsibilities, or proper due diligence. These will more than provide additional safeguards around the market selection of "quality" providers. The market may even benefit from *both* quality and quantity. That will lower costs and improve the standards and quality of information flowing into the market.

How can rating agency services be distinguished from other services?
We would highlight that the array of services that the rating agencies provide multiplies each passing year as they venture out from behind the protected enclave of their NSRSO status. They have expanded their array of data products, analytics offerings, default risk models, expanded in various areas of what can be defined as "capital markets research," launched a range of modular risk management products for counterparty risk, expanded and/or entered equity research, offered customized consulting services, and continue to ride the wave of unprecedented expansion in the global capital markets. Sometimes the growth of these other services is overlooked in the NRSRO debate.

Based on past history, it is not a surprise that Moody's and S&P will look to derail reform that streamlines entry into their businesses. After all, they use their protected status to get into everyone else's. We have always found it striking that a major rating agency can be meeting with an issuer that it rates while at one end of the hall it is offering a package of risk management services and at the other end of the hall be offering data products. It is a compelling sales pitch when there are already well-established sales channels. In effect, the NRSROs often find themselves in a position where are offering to sell an expanded array of services to a major

issuer where the NRSRO can have a major influence on that potential customer's cost of funding, opine on that potential customer's claims-paying ability, rate their mutual funds, score their counterparty risk, or evaluate their corporate governance. It starts to take on the appearance of the "offer you can't refuse." That type of market clout is rare and would appear to demand some regulatory framework—almost by definition.

Is this debate about First Amendment rights?
No. While some of the incumbent NRSROs have sought to use that ploy, we do not see how HR 2990 denies an independent voice the right to be anything other than just that in the market, i.e. independent. HR 2990 is in fact more about the market hearing even more independent voices. If there is anything in the spirit of the First Amendment, it is just that. One does not even have to be a seasoned skeptic to see this maneuver for what it is. The debate is not about the First Amendment; it is about the next dollar and who gets that dollar...and the dollar after that.

The desire to be classified as a publishing company more akin to the Wall Street Journal or Washington Post than a securities research firm has always dominated the legal strategy of the rating agencies. It might be an easier case to make if all large issuers of bonds were forced to pay millions of dollars a year to the New York Times to access the market, and buyers of those bonds, asset backed securities, and loans needed to pay tens and hundreds of thousands to Business Week to get the information required to remain in compliance with their investment parameters. The newspaper industry probably would not mind having Moody's and S&P's protected status, high profit margins, pricing power, and guaranteed volume.

In the end, this debate is about commerce and oversight of a major part of the underwriting chain and asset management business. While we would not begrudge anyone a shot at a last-ditch attempt to head off progress that might impinge on their margins, we are not aware how the increased array of independent research voices in the debt and equity markets have been encumbered from making their views clear whether it be under SEC or the even the NASD regulatory frameworks. We suspect that there are some companies out there who would like a little less free speech. They may not be happy with HR 2990 for promoting more of it. As it stands now, Moody's and S&P seem to be saying "Congress shall make no law respecting an establishment of competition to the NRSROs."

Will HR 2990 preclude a range of methodologies and impair information flows?
We are trying to see a scenario where the SEC takes the approach of micromanaging the methodologies of the rating agencies. The SEC is resource-constrained and is generally not staffed by Commissioners or professionals with extensive experience in the credit markets and the underwriting business for corporates, munis, structured securities, etc. On the other hand, they certainly are aware of what constitutes sound policies and procedures around conflicts of interest. HR 2990 inherently promotes a range of methodologies by promoting new entrants and also by including statistical models in the NRSRO picture. We see the "lack of diversity" argument against HR 2990 as more than laughable, especially since it has come from those firms that have been hindering diversity and competition for years. The fact that they often mimic each other in their ratings and methodologies should not be extrapolated to new entrants.

We also do not see why the SEC would look to be the arbiter of methodologies and ratings criteria. For example, it is hard to see where the SEC is going to tell an industry analyst at a rating agency he may be reviewing that the SEC is challenging him on his recovery rate assumptions for an oil company or call another analyst on his overemphasis on earnings volatility in his view of metals industry operating risk. If a rating agency *upgrades* only companies with rising leverage and declining earnings and vice versa on downgrades, even then the SEC might also not chime in. They will not have to. That NRSRO will have no customers.

Written Statement of Rapid Ratings Pty Ltd

Concerning

H.R. 2990, The Credit Rating Agency Duopoly Relief Act of 2005

Before

Committee on Financial Services
United States House of Representatives
One Hundred Ninth Congress

November 29, 2005
Philadelphia, Pennsylvania

I. INTRODUCTION AND OVERVIEW

Mr. Chairman, I appreciate the opportunity to appear today on behalf of Rapid Ratings Pty Ltd ('Rapid Ratings"). Dr. Patrick Caragata, the Founder, Managing Director and Chief Executive Officer of Rapid Ratings, is out of the country today and requested that I appear in his place. My name is Rick Roberts, and I am an attorney in Washington, D.C., with the firm of Thelen Reid & Priest. From 1990 to 1995, I served as a Commissioner of the United States Securities and Exchange Commission ("SEC"). In a couple of speeches in 1992, I highlighted what I viewed as the potential problems imbedded both in the operations of the current credit rating agencies and in the nationally recognized statistical rating organization ("NRSRO") designation criteria utilized by the SEC. Unfortunately, not much has changed since then, except that the potential problems in the credit rating agency area that I highlighted in 1992 have now been generally identified as real problems.

During the last three years, Rapid Ratings has been actively engaged in filing formal statements in response to regulatory and legislative reviews of international rating agencies in the U.S. and abroad. Its submissions include:

- November 3, 2003: http://www.sec.gov/rules/concept/s71203/rapid110603.htm.
- Nov 8, 2004 response to The International Organizations of Securities Commissions in Madrid http://www.rapidratings.com/pdf/IOSC_compliance_rapid_ratings_corporate_credit_rating_agency.pdf.
- June 8, 2005: http://www.sec.gov/rules/proposed/s70405/rrp060805.pdf.
- July 15, 2005: Letter from Rapid Ratings to Hon. Michael Fitzpatrick, Member, Subcommittee on Capital Markets, Committee on Financial Services, United States House of Representatives, 1516 Longworth HOB, Washington, D.C. 20515 Re: H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005.

Rapid Ratings is pleased to offer its testimony today on this important legislation that it believes will introduce competition and additional integrity to the rating process for debt securities and will reduce systemic risk in the market. As I will discuss more fully, the current duopoly, in which two credit rating agencies hold eighty percent of the market share, while a

third has fifteen percent, has stymied innovation, prevented evolutionary competition, and left investors with inadequate warnings about major corporate collapses. Resolution of those problems lies in the hands of legislators and regulators. The action of Congressman Fitzpatrick to introduce targeted and enhanced competition would make credit ratings more accurate, protect investors, reduce the possibility of unanticipated credit declines and reduce the potential for systemic risk in our capital markets (see attached Figure 1). In my view, H.R. 2990 is a catalyst for reforms that will greatly enhance the quality of information provided to investors.

It is important to recall why we are here and which factors have motivated H.R. 2990. The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), approved by Congress in response to the corporate scandals at Enron and WorldCom, addressed weaknesses in two key corporate governance areas: transparency and accountability. But, in Section 702 and elsewhere, the Act also emphasized a need for reviewing and improving performance measurement by key market participants, such as securities dealers, rating agencies and audit firms. Section 702 specifically asked for a study by the SEC into:

- the role of the credit rating agencies in evaluating the issuers of securities;
- the importance of that role to investors and to the functioning of the securities markets;
- any impediments to the accurate appraisal by the credit rating agencies of the financial resources and risks of issuers of securities;
- any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers;
- any measures which may be required to improve the dissemination of information concerning such resources and risks when credit rating agencies announce credit ratings; and
- any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate such conflicts.

In essence, the Sarbanes-Oxley Act represented an initial phase of reforming securities markets but also anticipated a second phase in other areas, most notably, from my perspective, the rating agency industry and how it is regulated.

I view H.R. 2990 as a natural evolution of Sarbanes-Oxley that, if enacted, will bring closure to many of the unresolved issues identified in Section 702 of the Act. It has been three years since the passage of Phase 1, and so it is now time for Congress to address Phase 2. Without such reform, our debt securities markets will continue to be prone to systemic risk; and there will be a strong potential for the good work in Sarbanes-Oxley to be undermined unless the two key elements of corporate governance are tied together with performance measurement. The enhanced standards of transparency and accountability (which together are focused on compliance-based inputs) need to be combined with performance measurement (which is focused on outputs), and not just transparency and accountability tied together on their own.

The issue of systemic risk needs to be brought under a bright light as well. Currently, the use of NRSRO rating agency ratings are embedded in hundreds of pieces of legislation, regulation and commercial contracts. The risk arises because these utilizations of NRSRO ratings employ the terms "investment grade" and "sub-investment" grade as if they were the only choices for classifying the risk of assets. In effect, this approach has turned the ratings scale into a binary-choice system, whereby Good (investment grade) Assets are officially approved and Bad (sub-investment grade) Assets are not approved.

As a result, when the rating of a listed company and its securities slip below BBB-, many institutional investors are forced to dump the securities because they are no longer authorized to hold or invest in such assets. This could easily trigger a financial crisis if enough companies are pushed into sub-investment grade territory by NRSRO rating actions. The liquidity crisis would arise because there would be large volumes of securities dumped simultaneously on the market with insufficient, if any, buyers. This whole process is triggered not only by the unthinking use of NRSRO ratings triggers, but more particularly by the absence of a transition phase between

investment grade and sub-investment grade, and the absence of early warnings from the current NRSROs in major corporate collapses.

Such a new category would be called borderline investment grade and would cover at least two rating notches (BB+ and BB) where the probability of default is still modest. This low probability of default underlines the short-sightedness of a binary choice system that forces the dumping described above. The way the new system would work is that companies would be required to dispose of non-investment grade assets over time, rather than all at once (see attached Figure 1). Thus, I strongly recommend that H.R. 2990 be amended to direct the GAO to review the issue of systemic risk embedded in credit rating the markets.

II. RAPID RATINGS

Rapid Ratings was founded in 1997 and is an independent global corporate credit rating agency headquartered in Australia, with offices in Australia, New Zealand, Singapore, the UK, Canada and the U.S. Rapid Ratings is currently licensed by the Australian Securities & Investment Commission as a credit rating agency to provide financial advice to wholesale and retail markets. Rapid Ratings anticipates that it will file an application seeking to obtain designation as an NRSRO with the SEC in the near future.

Using proprietary software, Rapid Ratings rates approximately 15,000 listed companies globally, including 7,000 in the U.S. Its core business model is to license its ratings information and related analysis to investors. Rapid Ratings' primary clients are institutional investors, private banks, fund managers, accounting firms, brokers and financial advisors, all of whom use its ratings to assess the financial health of companies in their clients' portfolios so as to minimize the risk of big negative surprises such as Enron, Parmalat, *etc.* Hence, Rapid Ratings follows the original rating agency model of being paid by subscribers rather than by issuers of securities. Moody's, Standard & Poor's ("S&P") and Fitch began to shift away from the subscription model

as the concept of NRSRO status was introduced in 1975 by the SEC, following debate about reforming the debt markets in the aftermath of the collapse of Penn Central in 1970.[1]

Unlike current NRSROs, Rapid Ratings' credit ratings assess the financial health of an institution based on industry-specific quantitative models. Rapid Ratings' system utilizes twenty-four industry specific models that analyze the audited financials of each company relative to its global peers, using a global database of more than 300,000 companies with more than thirty years of data. The ratings are derived solely from publicly disclosed financial statements.

Rapid Ratings' track record for anticipating the collapse of major companies is excellent. Rapid Ratings assessed GM's credit strength as being well below investment grade when commercial coverage of GM began in early 2004, and back testing shows that GM became sub-investment grade in 2000. In contrast, S&P and Moody's downgraded GM to non-investment grade in May 2005. Rapid Ratings assessed Delphi's credit risk as well below investment grade when it first began commercial coverage in early 2004, and back testing showed that Delphi had been sub-investment grade since 2001, and distressed since 2003. In contrast, S&P and Moody's downgraded Delphi to non-investment grade in late 2004.

Rapid Ratings also anticipated Air Canada's December 2003 default in 2001, Air New Zealand's October 2001 default in 1999, AMP's (Australia) April 2003 capital crisis in 1999, and Stelco's (Canada) January 2004 default in 1999. In addition, back tests of its quantitative models establish that Rapid Ratings would have also predicted the collapse of Enron and Parmalat four to six years, respectively, before current NRSROs took action, as well as predicted the largest corporate collapse in Australian history (HIH Insurance) in 2001 by five years (1996).

[1] "...In the 1970s, the major rating agencies including Moody's began the practice of charging issuers as well as investors for rating services. The rationale for this change was, and is, that issuers should pay for the substantial value objective ratings provide in terms of market access. In addition, it was recognized that the increasing scope and complexity of the capital markets demanded staffing at higher levels of compensation than could be received from publication subscriptions alone."
http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=history

III. CURRENT APPROACH TO RATINGS AND IMPLICATIONS

Since the NRSRO concept was created in 1975, it has become a regime with significant long-term implications.[2] The original intent of the SEC regulations in 1975 was rather narrow: "to provide a method for determining capital charges on different grades of debt securities under the Commission's net capital rule for broker-dealers, Rule 15c3-1 under the Exchange Act. . . ." Over time, however, the importance of the NRSRO designation has far eclipsed its parochial origins. Today, numerous pieces of legislation and regulation incorporate NRSRO references and requirements,[3] with the result that most financial institutions in the United States (banks, insurance companies, mutual funds, pension funds, *etc.*) are required by law to incorporate NRSRO ratings in their business decisions. As a consequence of the current rating scheme, the

[2] John Moody invented credit ratings when he began issuing letter rating symbols to railroad debt in 1909. Moody began rating corporate bonds in 1913 and by the end of that year Fitch Publishing Company was founded. Poor's Publishing, which traced its roots to financial manuals first published in the 1860's, began rating corporate bonds in 1916. Thus was the credit ratings business born—from publishing firms selling subscriptions of statistically-based analysis to investors. As Moody's puts it in its company history, "Then -- as now -- Moody's ratings were based on public information and assigned without the request of issuers." Yet much has changed since then and the credit ratings business today is very different from its origins.

Fast forward to the 1970's, when the NRSRO concept was first created. After the crisis created by the Penn Central bankruptcy in 1970, investment bankers began to use credit ratings in debt offerings to supplement their internal due diligence. As usage increased and the importance of the credit ratings escalated, the publishing firms decided to charge debt issuers for assigning ratings to new debt. However, at the point that the market began to rely heavily on credit ratings, they were primarily statistically driven from publicly available information.

New ratings methodologies evolved once the decision was made to charge issuers for ratings. These are analyst intensive, in part to provide safeguards against the conflicts inherent in charging fees to the issuers being rated. A minimum of two analysts were assigned to every issuer and ratings are reviewed and approved by committee. These methodologies have worked well to provide safeguards against conflicts, but they can also be an impediment to timely action.

In 1975, the SEC, looking for a convenient metric to define net capital rules for broker/dealers, decided to use credit ratings as a proxy for the risks associated with debt securities, and fashioned the NRSRO definitions around the nascent issuer-paid business model. The SEC had no inkling of how widespread the usage of the NRSRO term would become. If it had, it probably would have given more thought to the NRSRO concept, something it is now trying to do. "Nationally recognized" was a convenient way of short-cutting the task of actually defining what makes a good credit rating. "Statistical ratings" is a vestige of the original methodologies which were largely quantitative.

[3] http://www.sec.gov/rules/concept/s71203/rapid110603.htm#P48_2869#P48_2869.

NRSROs have tremendous influence and market power, both domestically and globally, and have generated tremendous returns for their investors. [4]

Although the SEC has proposed the adoption of a rule defining NRSROs, currently such status is conferred by means of a staff no-action letter. Moreover, that gateway to NRSRO designation is very narrow – if not entirely closed. Over the past thirty years, only a handful of organizations have achieved NRSRO designation.

There are currently five key factors that the SEC staff uses to assess before assigning NRSRO status:

1) Whether the company is nationally recognized as an issuer of credible ratings by users of securities ratings;
2) Whether the company maintains substantial financial resources to operate independently of the companies it rates, more than ample professional staffing, and an organizational structure that ensures its ability to produce credible ratings;
3) Whether the company has sound procedures and processes in place that enable it to support its ability to produce credible ratings;
4) Whether the company has access to senior management of the companies that it rates on a year-round basis; and
5) Whether the company has in place sound procedures to prevent the misuse of non-public information obtained as part of the ratings process.

According to the SEC, however: "The single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings."

[4] http://www.sec.gov/rules/concept/s71203/rapid110603.htm#P51_4819#P51_4819.

As applied by the SEC, the U.S. Department of Justice has noted that, historically,[5] the NRSRO criteria act as a barrier to entry, and in a catch-22 manner. A new rating agency cannot obtain national recognition without NRSRO status, and it cannot obtain NRSRO status without national recognition. The effect of this catch-22 has been to preserve a duopoly that has thwarted competition and innovation.

I believe that additional competition will ensure earlier warnings to the marketplace of potential problems, greater accuracy in ratings, broader coverage of issuers, lower costs to issuers and investors, and greater independence and objectivity. Greater competition is likely to reduce prices for both buy-side and sell-side users of ratings. At the same time, multiple views based on different methodologies will result in a more critical analysis of borrowers that will more efficiently allocate capital, reduce informational disparities among investors, and reduce surprises that produce systemic shocks.

IV. PROBLEMS WITH CURRENT APPROACH

Objectivity, independence and integrity are necessary to ensure the validity of the ratings process. Current NRSRO criteria were designed for rating agencies with an issuer-paid business model. Despite their origins of being paid largely by subscribers, since NRSRO status was introduced in 1975, the largest rating agencies have been increasingly (and now predominantly) paid by issuers of debt to rate those parties, which I refer to as a Type 1 Model. This was perhaps one of the unintended consequences of the creation of NRSRO status. Type 1 rating agencies employ highly skilled and highly paid people that go onsite to acquire non-public information to rate companies. New generation rating agencies, such as Rapid Ratings, have an entirely different business model (Type 2 Model).[6]

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[5] http://www.sec.gov/rules/concept/s71203/rapid110603.htm#P69_8177#P69_8177.

[6] The current NRSRO guidelines have fossilized a specific ratings process and have discouraged innovation even by current Type 1 NRSROs. Despite acquiring Type 2 firms such as KMV and Algorithmics, firms with innovative quantitative credit scoring models, current Type 1 NRSROs have been reluctant to integrate these capabilities into their traditional ratings process, preferring instead to offer them as supplemental capabilities. Under the current

New generation rating agencies are paid by investors or other third parties (banks, insurance companies, investment funds, pension funds, large creditors, *etc.*) to rate second parties (listed and/or unlisted companies and their securities) and use only publicly available information. Type 2 rating agencies also typically use software rather than analysts. Thus, in the Type 2 Model, there may be no contact between the rating agency and the companies it rates and thus little potential for conflict of interest. Rating agencies that follow a subscription business model do not need to manage the conflicts of interest that arise when the issuer being rated is also paying for that rating. In assessing eligibility for NRSRO status, it would be unfair to require a Type 2 company to conform to criteria that pertain only to Type 1 companies that have such conflicts.

Once barriers to entry are made less onerous and more balanced, new entrants will bring new ideas and a refreshing level of competition to the industry. Eventually, if they have the right technology and are provided a level playing field so they can compete on equal terms, Type 2 rating agencies will expand ratings coverage and improve ratings' timeliness and accuracy because of their ability to process tens of thousands of companies at low cost. That is the critical catalyst for enhanced and sustainable competition. Just like Henry Ford promoted the development of "a car for every family", the Type 2 rating agencies will be able to deliver "a rating for every company".

Currently, the Big Three rating agencies only rate between 10% and 25% of listed companies globally and less than 0.1 % of registered companies in each major securities market because of the cost and expertise constraints they impose on the markets. Rapid Ratings can rate all companies for which it obtains audited financials, and its current low-end capacity level is several thousand companies per day.

NRSRO guidelines, it is preferable for a Type 2 firm such as KMV to be acquired by an existing Type 1 NRSRO because designation as a stand-alone entity would be difficult if not impossible.

V. RECOMMENDED SOLUTIONS

Our recommended approach, and one that we have expressed to the SEC, would be to reduce the weight placed on the existing input-based criteria, such as access to non-public information, and focusing instead on output criteria. In our view, the output criteria should be based on: (a) the track record of the rating agency in predicting individual corporate declines and collapse; (b) the track record of the rating agency in anticipating corporate turnarounds; and (c) the ability of the rating to anticipate corporate demise ahead of the share price. If a rating agency cannot beat the share price in anticipating corporate collapse, it is questionable if that agency is adding any new information to the market. Typically, the traditional Type 1 rating agency ratings lag the share price by 1-3 years in anticipating the demise of companies.[7]

VI. THE CREDIT RATING AGENCY DUOPOLY RELIEF ACT OF 2005

Rapid Ratings believes H.R. 2990 would achieve many of the goals that are necessary to promote greater efficiency in the debt markets. It would remove most of the current restrictions, instituting a registration process for rating agencies that have been in business for more than three years. The legislation would substitute "Registered" for "Recognized" in the NRSRO acronym. It also would permit quantitative firms to be registered and would allow subscription fees to be charged for ratings by not requiring wide dissemination of ratings at no cost.

This legislation goes a long way toward removing the barriers to entry created by the current regulatory standards, while assuring the integrity of the rating process by providing credible market-based standards. My specific comments to the bill are outlined below.

[7] Sources include: Pinches, George E. & J. Clay Singleton, 1978, The Adjustment of Stock Prices to Bond Rating Changes, vol. 33 Journal of Finance pp, 29-55 at 39. Odders-White, Elizabeth R. and Mark J. Ready, 2003, Credit Ratings and Liquidity, Department of Finance, University of Wisconsin. Creighton, Adam, Luke Gower and Anthony Richards , 2004, The Impact Of Rating Changes In Australian Financial Markets, Research Discussion Paper 2004-02 , March 2004, System Stability Department, Economic Research Department, Sydney, Reserve Bank of Australia. Macey, Jonathan R. 2002, Cornell Law School, Testimony before the US Committee on Governmental Affairs, March 20, 2002 , "NRSROs and Investor Protection" and additional research by Rapid Ratings.

A. Definition of a Statistical Rating Organization

As currently written, H.R. 2990 contains two key definitional requirements. First, it requires that the SRO have been in the business, and, in fact, have had as its primary business, the issuance of publicly available ratings for the three prior consecutive years. The definition of SRO specifies that the methodology used by an organization may be either quantitative, such as that employed by Rapid Ratings, or qualitative – or both.

1. Credible Business

In my view, the requirement that a business be credible is an appropriate test that contains two measures: one that examines the organizational and financial resources of the firm, and one that examines the quality and acceptance of its products. In connection with operational integrity – or credibility - I believe that it is important to retain in the legislation the clear statement that the legislation is intended to encompass both organizations that employ qualitative as well as quantitative measures – or a combination thereof, and that are paid by either the issuers or the investors.

Although the SEC has indicated an openness to quantitatively oriented ratings agencies qualifying for NRSRO status, the recently proposed NRSRO definitions are biased against quantitative firms. For example, the SEC notes in its release accompanying the rulemaking, a number of benchmarks, including the experience and training of analysts, number of issues covered by each analyst, and information sources within issuers as determinative of operational integrity. These criteria, and the level of operational funding needed to support the functions, while relevant to qualitative rating organizations (Type 1: paid by issuers), have little relevance to organizations such as Rapid Ratings and other quantitative firms that determine their ratings based on software models and public information (Type 2: paid by investors and other subscribers). In order to assure that a level playing field is provided between the two types of rating organizations, I believe that it is important to retain specific reference to both quantitative

as well as qualitative ratings methods and organizations in H.R. 2990, and to include specific reference to Type 1 rating agencies paid by issuers and Type 2 rating agencies paid by subscribers (such as institutional investors). This will ensure that the pre-1975 practice of having ratings largely paid for by investors and other subscribers is revived by new generation rating agencies with new technology and a strong record for providing early warnings to the market.

I also believe that substituting a "credible ratings" requirement in lieu of the current "nationally recognized" or "generally accepted" language is a far more effective standard for judging rating agencies and is one that allows for both a market franchise and the evolution of competition. This criteria, in fact, has been criticized most frequently as being the most anti-competitive language in the current NRSRO definition.

In determining the credibility of a rating agency's ratings, the SEC should focus on independently verifiable statistical measures that support the agency's claim of credible and reliable ratings. As I noted above, output criteria based on: (a) the track record of the rating agency in predicting individual corporate declines and collapse; (b) the track record of the rating agency in anticipating corporate turnarounds; and (c) the ability of the rating to anticipate corporate demise ahead of the share price are more important, objective and reliable evidence than the strength of a brand name that may be recognized as the result of marketing or legacy. No organization will be successful or able to fund operating expenses for any sustained period of time unless it has market acceptance. But there must be a legal and regulatory level playing field to ensure that new NRSRO entrants have the opportunity to gain market acceptance.

2. Public Availability of Ratings

Although H.R. 2990 requires that ratings must be publicly available, it substantially improves upon the current SEC requirements, which require that the ratings be made available to the public for free. By allowing a subscription based business model, and not just a ratings fee model, H.R. 2990 permits additional competition from Type 2 firms such as Rapid Ratings.

B. Registration and Elimination of SEC Designation

I believe that the registration proposal set forth in H.R. 2990 will achieve the purpose of enhancing competition and, at the same time, assuring that the SEC has the power to apply appropriate controls to ensure the integrity of rating organizations. Among the benefits of the proposal are that it provides for a transparent process, sets definite time periods for action, and requires agency action that can be appealed based on objective measures. In addition, I believe that the language of the legislation is broad enough to permit the SEC wide latitude in rulemaking to address any concerns that may develop over time.

C. Filing Requirements

As part of the registration process, applicants would be required to disclose information regarding any conflicts of interest, and its credit rating methodologies, performance measurement statistics and procedures to prevent the misuse of non-public information. Each of these requirements form an ethical and empirical basis by which the SEC and potential users of ratings can measure the integrity and value of the organization offering particular ratings.

VII. CONCLUSION

Designating additional Type 1 rating agencies as NRSROs via a modified NRSRO definition will not necessarily generate sustainable higher competition that will enhance early warnings and reduce systemic risk. The SEC proposed NRSRO definition makes it difficult for rating agencies pursuing innovative business models to attain NRSRO status. Further, if new Type 1 rating agencies enter the market, they are unlikely to take much business away from S&P, Moody's and Fitch because the market has little interest in a fourth, fifth or sixth opinion from a similar business model (*i.e.,* paid for by issuers). Having a third opinion from Fitch has been a very hard sell to the marketplace. So while there is room for a Me 1, Me 2 and Me 3

system, the entry of Me 4 and Me 5 have hardly generated excitement, while the entry of Me 6, Me 7 and Me 8, *etc.*, would create a big yawn.

The real potential for enhancing ratings competition arises with the entry of innovative rating agencies that offer alternate business models. Type 2 rating agencies, which mark to market, use models or software and are paid by the buy-side, offer excellent track records of issuing early warnings, objectivity and independence and broad coverage.

Any reform to the currently restrictive NRSRO criteria raises a concern among some market participants over "ratings shopping," *i.e.*, that issuers would obtain ratings from agencies that offer the most lenient ratings criteria. Performance benchmarks available to the SEC in determining whether an agency provides credible ratings would address this concern. Verifiable statistical measures such as default statistics and rating comparisons on issuers rated jointly by multiple agencies clearly reveal any agency which is systematically an "easy grader". In addition to the tools available to the SEC, there would be reputational risk for any such rating agency among investors. This concern is already addressed in the marketplace, where market pricing mechanisms such as bond spreads routinely "second guess" the credit rating, and would highlight firms that are consistently assigning higher ratings than would be warranted by an issuer's financial condition.

Another concern mentioned with regard to reducing barriers to NRSRO entry involves market confusion. The concern is that an increase in competitors would disrupt debt markets by introducing additional rating symbologies, definitions and methodologies. The reality is that the debt market is largely institutional. Institutional investors already utilize hundreds of sources of equity research without deleterious effect. There are currently over 300 distinct sources of equity research, each with different methodologies, symbologies and track records. The SEC, along with other U.S. regulators, has been actively encouraging additional competition among equity research providers as it has been administering the independent research provisions of the

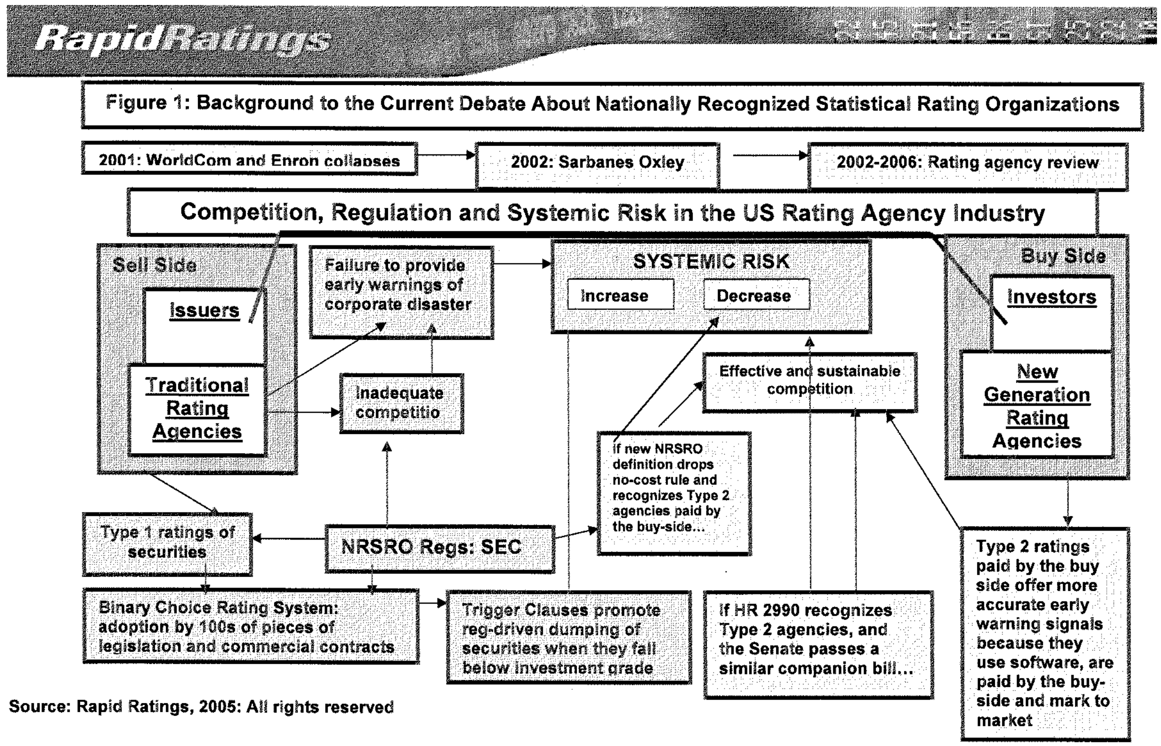
Global Research Settlement. There is no reason why additional sources of credit research would be any less desirable than additional sources of equity research.

In conclusion, if a level playing field is created to permit rating agencies with innovative business models such as those that mark to market, are based on software and are paid by investors to compete effectively with Type 1 rating agencies (which are paid by issuers), there will be significant benefits to the market, namely:

1) earlier warnings to the market of potential problems,
2) enhanced protection and choice for investors,
3) greater accuracy in ratings,
4) broader coverage of securities and issuers,
5) lower costs to issuers and investors,
6) greater independence and objectivity, and
7) less risk of systemic shocks.

Again, I appreciate the opportunity to appear today before the Committee. In my view, the reduced barriers to entry afforded by H.R. 2990 will provide substantial benefits to the markets and improve the efficiency of the capital allocation process. The global investment community has looked for many years at the U.S. standards for rating agency designation. H.R. 2990, if successful, will provide an enduring, positive effect on global markets because new U.S. legislation and regulations affecting credit rating agencies are studied intensely and are often adopted in other countries around the world. It will also represent a successful complement to the Sarbanes-Oxley Act's reform of our capital markets.

I will be glad to attempt to respond to any questions that you may have at the appropriate time.


RapidRatings
Figure 1: Background to the Current Debate About Nationally Recognized Statistical Rating Organizations
2001: WorldCom and Enron collapses
2002: Sarbanes Oxley
2002-2006: Rating agency review
Competition, Regulation and Systemic Risk in the US Rating Agency Industry
Sell Side
Issuers
Traditional Rating Agencies
Failure to provide early warnings of corporate disaster
Inadequate competitio
SYSTEMIC RISK
Increase
Decrease
Effective and sustainable competition
Buy Side
Investors
New Generation Rating Agencies
If new NRSRO definition drops no-cost rule and recognizes Type 2 agencies paid by the buy-side...
Type 1 ratings of securities
NRSRO Regs: SEC
Type 2 ratings paid by the buy side offer more accurate early warning signals because they use software, are paid by the buy-side and mark to market
Binary Choice Rating System: adoption by 100s of pieces of legislation and commercial contracts
Trigger Clauses promote reg-driven dumping of securities when they fall below investment grade
If HR 2990 recognizes Type 2 agencies, and the Senate passes a similar companion bill...
Source: Rapid Ratings, 2005: All rights reserved

STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

H.R. 2990

CREDIT RATING AGENCY DUOPOLY RELIEF ACT OF 2005

NOVEMBER 29, 2005

EXECUTIVE SUMMARY

The Investment Company Institute commends the House Financial Services Committee for holding this hearing on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005," in order to gain a better understanding of the role of credit rating agencies in our securities markets.

Mutual funds employ credit ratings in a variety of ways – to help make investment decisions, to define investment strategies, to communicate with their shareholders about credit risk, and to inform the process for valuing securities. Money market mutual funds, which invest a significant amount of their portfolios in securities rated by NRSROs, provide a compelling illustration of the importance of sound credit ratings and rating agencies to investors. Money market funds currently hold $2 trillion in assets.

To promote the integrity and quality of the credit ratings process and, in turn, serve the interests of investors who utilize credit ratings, we believe there are several steps that should be taken. First, the NRSRO designation process should be reformed to facilitate the recognition of more rating agencies and thereby introduce much needed competition in the credit rating industry. Second, there should be appropriate regulatory oversight by the SEC to ensure the credibility and reliability of credit ratings. Third, investors should have regular and timely access to information about NRSROs to provide investors a continuous opportunity to evaluate the ratings they produce. Finally, NRSROs should have some accountability for their ratings in order to provide them with incentive to analyze information critically and to challenge an issuer's representations.

The ICI strongly supports the goals of H.R. 2990. Increased competition, appropriate SEC oversight, greater transparency, and heightened accountability - these are the right objectives for reform of the credit rating industry, from the perspective of mutual funds, other investors, and the securities markets as a whole.

I. INTRODUCTION

Good morning. I am Paul Stevens, President of the Investment Company Institute, the national association of the U.S. investment company industry. ICI members include 8,518 open-end investment companies or "mutual funds," 663 closed-end funds, 148 exchange-traded funds and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $8.5 trillion, representing more than 95 percent of all assets of U.S. mutual funds. These funds serve approximately 86.7 million shareholders in more than 51 million households.

Mutual funds and fund shareholders have a significant stake in the soundness and integrity of the credit rating system. I commend the Committee for holding this hearing on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005," which is intended to improve the quality of credit ratings by fostering competition, transparency and accountability in the credit rating industry and to address concerns regarding the current "NRSRO" designation process. This is my second opportunity as President of the ICI to testify before the House Financial Services Committee, so ably led by you, Chairman Oxley. Under your leadership, and that of Ranking Member Frank, and Capital Markets Subcommittee Chairman Baker and Ranking Member Kanjorski, the Committee has been active in critically important issues affecting not just mutual funds, but our capital markets. I also would like to recognize Congressman Fitzpatrick for his leadership in this important legislation.

Credit rating agencies play a significant role in the U.S. securities markets generally, and vis-à-vis mutual funds in particular. As we have noted in response to several proposals from the Securities and Exchange Commission relating to credit rating agencies and NRSROs and in other statements relating to NRSRO oversight, the ratings published by credit rating agencies help inform the investment decisions of mutual funds and other institutional investors. The SEC and other regulators rely upon these ratings as indicators of investment risk for various regulatory purposes. Maintaining the integrity and quality of the credit ratings process is therefore essential to sustaining investor confidence and to promoting the proper functioning of our capital markets.

We believe it is timely and appropriate for Congress to consider legislation to advance several objectives in this area. First, legislation should facilitate the designation of more rating agencies as NRSROs in order to introduce much needed competition in the credit rating industry. Creating competition would provide NRSROs even stronger incentives to ensure that their ratings are of the highest quality and reliability. Second, legislation should ensure appropriate oversight by the SEC to ensure the continued integrity and quality of these ratings. Third, legislation should assure disclosure of information about NRSROs to investors and provide them a continuing opportunity to evaluate NRSROs, thereby promoting efficient functioning of the credit rating industry. Finally, legislation should assure that NRSROs have some accountability for their ratings processes in order to provide them with incentive to analyze information critically and to challenge an issuer's representations.

II. IMPORTANCE OF CREDIT RATING AGENCIES AND NRSROS TO THE FUND INDUSTRY

A. Use of Credit Ratings

There is no question that credit ratings play an important role in our securities markets. Like other institutional investors, mutual funds utilize these ratings in analyzing the credit risks of securities. In fact, NRSRO-rated securities form an important component of the portfolios that funds manage for the benefit of their shareholders. For example, money market funds currently hold $2 trillion in assets. The Institute estimates that taxable money market funds invest about 50 percent of their non-government portfolio securities in NRSRO-rated securities. In addition, according to one source, tax-exempt money market funds invest an even larger amount, approximately 90 percent of their assets, in securities rated by NRSROs.[1]

Credit ratings also play an important role in communications between funds and their shareholders - communications that inform the purchase decisions of millions of American investors. Many funds incorporate ratings criteria into shareholder disclosures regarding the investment policies and strategies of the fund. For example, such disclosure may include a description in a fund prospectus regarding the percentage of its portfolio invested in bonds rated in a particular category by an NRSRO. Many corporate and municipal bond funds now provide shareholders with a graph or table showing the percentage of the portfolio invested in each rating category of one or more NRSROs. Some funds even provide the ratings of individual securities in the schedule of investments provided to shareholders as a method of communicating with shareholders about the credit risks taken by a fund.

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[1] iMoneyNet, *Money Fund Report* at 28 (October 7, 2005).

Ratings also play an important role in the valuation of mutual fund shares. Many mutual funds use pricing services in valuing debt securities, some of which trade only infrequently. The rating assigned to securities by a rating agency may influence the valuation determinations of pricing services and ultimately the calculation of the net asset value of mutual funds that hold such securities.

Finally, some investment companies, particularly institutional money market funds, obtain credit ratings for their own shares.

B. Money Market Mutual Funds and Investment Company Act Rule 2a-7

The most significant influence of credit ratings on the fund industry is on the $2 trillion invested in money market mutual funds. Money market funds are a truly remarkable chapter in the history of U.S. mutual funds. Initially, money market funds were used as savings vehicles; today retail and institutional investors alike rely on them as a cash management tool, because of the high degree of liquidity, stability in principal value, and current yield that they offer. ICI estimates that between 1980 and 2004, roughly $100 trillion flowed into, and the same amount out of, money market funds.

If money market funds are an industry success story, they also most certainly are an SEC success story. Since 1983, money market funds have been governed very effectively by Rule 2a-7 under the Investment Company Act of 1940. Since Rule 2a-7 was adopted, money market fund assets have grown nearly 1000 percent (from $179 billion to $1.9 trillion).

Rule 2a-7 limits the types of securities in which money market funds can invest in order to help them achieve the objective of maintaining a stable net asset value of one dollar per share. Credit ratings form an integral part of these limitations. For example, money market funds may only invest in securities either rated by an NRSRO in its two highest short-term rating categories or, if unrated, as determined by the fund's board of directors to be of comparable quality. In general, money market funds also cannot invest in certain securities, including most asset-backed securities and certain guarantees, unless they have been rated. Finally, Rule 2a-7 requires money market fund advisers to continuously monitor the ratings of portfolio securities and to take certain actions in the event a security is downgraded. While Rule 2a-7 does not completely limit money market funds to rated securities, it effectively requires fund advisers to incorporate any available ratings into the analysis of appropriate securities to be held by these funds.

It is important to note that no government entity, such as the FDIC, insures money market funds. Nevertheless, despite an estimated $200 trillion flowing into and out of money market funds over the past 25 years, through some of the most volatile markets in our history, only once has such a fund failed to repay the full principal amount of its shareholders' investments. In that case, a small institutional money fund "broke-the-buck" due to extensive derivatives-related holdings.

It is critically important that this record of success achieved under Rule 2a-7 continues for the benefit of money market fund investors. This, in turn, depends on the ratings issued by NRSROs providing credible indications of the risk characteristics of those instruments in which money market funds invest.

III. THE NRSRO DESIGNATION PROCESS SHOULD PROMOTE COMPETITION

The mutual fund industry is one in which intense competition has brought unparalleled benefits to investors. I firmly believe that robust competition for the credit ratings industry is the best way to promote the continued integrity and reliability of their ratings. Unfortunately, the current designation process does not promote -- but, in fact, creates a barrier to -- competition. Since the SEC first created the NRSRO designation in 1975, there have been only a handful of rating agencies that have achieved the designation. Given the competitive advantage and benefits that accompany the NRSRO designation, it is hard to imagine that other existing credit rating agencies or potential new entrants to this market would not want to obtain such a designation. Nor are new rating agencies likely to be able to compete effectively without the NRSRO designation.

As I discussed earlier, money market funds generally must invest in securities rated at a certain level by an NRSRO. It is therefore necessary for many issuers to have their securities rated by an entity designated as an NRSRO (as opposed to a rating agency without such a designation), to avoid losing access to a substantial pool of investment capital. Similarly, ratings from an NRSRO may give issuers access to investments from state and local governments, which often are required by law to invest in securities with specified ratings. Broker-dealers, too, have an incentive to hold NRSRO-rated securities in order to maintain their capital adequacy under the federal securities laws. Given the valuable attributes accompanying the NRSRO designation, issuers and other users of credit ratings have little incentive to pay a rating agency that does not qualify as an NRSRO for its ratings, even if they believe that the

ratings themselves may be of superior quality. This lack of competition eliminates an important incentive for NRSROs to maintain and improve the quality of their credit ratings.

To encourage more competition, the NRSRO designation process must be improved. The current SEC process for designating credit rating agencies through the issuance of no-action letters has not worked effectively. We share the concerns of others regarding the length of time necessary to obtain a no-action letter and the limited types of credit rating agencies deemed eligible for NRSRO status. The SEC's vague "national recognition" standard gives rise to the oft-noted "chicken and egg" dilemma: an organization must be nationally recognized to be designated as an NRSRO, but cannot realistically expect to obtain national recognition without the NRSRO designation. These factors all have contributed to the small number of currently recognized NRSROs.

In place of this no-action process, we recommend mandatory, expedited registration with the SEC. We are therefore pleased that H.R. 2990 properly moves the basis for NRSRO designation from a "national recognition" standard to an SEC registration requirement.

While such changes to the NRSRO designation process would be welcome, they also will require the SEC to reassess its existing regulations that rely on and refer to NRSROs. For example, the credit rating requirements in Rule 2a-7 will need to be reexamined if there is a significant increase in the number of NRSROs, to avoid funds having to monitor the ratings issued by each and every one of those organizations.

IV. NRSROS SHOULD BE SUBJECT TO EFFECTIVE REGULATORY OVERSIGHT

While the implementation of a new NRSRO designation process would undoubtedly spur competition, at the same time, to ensure the integrity and quality of credit ratings, there must be effective regulatory oversight by the SEC of NRSROs after their initial designation. We believe this can be achieved through a combination of (1) periodic filings with the SEC, and (2) appropriate inspection by the SEC, coupled with adequate enforcement powers. H.R. 2990 should provide the SEC with authority sufficient to implement such a system.

Currently, the SEC has little basis on which to assess the continued credibility and reliability of credit ratings issued by an NRSRO after it has received its designation through the no-action process. It is my understanding that NRSROs are subject to infrequent, if any, SEC examinations. In addition, under the terms of the no-action letters granted to NRSROs, once a rating agency has been granted the NRSRO designation, it is required to notify the SEC only when it experiences material changes that may affect its ability to meet any of the original recognition criteria. Given the heavy financial impact that a loss of NRSRO designation would have on a rating agency, NRSROs have a strong disincentive to report any such changes. It is unrealistic to premise regulation altogether on self-policing and self-reporting.

H.R. 2990 would require that certain important information – conflicts of interest, the procedures used in determining ratings, ratings performance measurement statistics, and procedures to prevent the misuse of non-public information – be provided to the SEC upon registration. We believe that NRSROs also should be required to report to the SEC, on an

annual basis, that no material changes have occurred in these areas. Similarly, NRSROs should be required to report any material changes that do occur on a timely basis, and this information should be made available promptly to investors who rely on NRSRO ratings. We recommend that H.R. 2990 be amended to provide for such additional reporting requirements.

Finally, it is important that the SEC devise an appropriate inspection process with respect to NRSROs. Such a process can and should be tailored to the nature of their specific business activities. Nevertheless, some form of periodic examination seems imperative in light of the important and pervasive role that credit ratings play in the securities markets.

V. TRANSPARENCY OF INFORMATION TO INVESTORS SHOULD BE INCREASED

In discussions with our members, they have emphasized the importance to them, as investors, of access to information about an NRSRO's policies, procedures and other practices relating to credit rating decisions. In particular, it would be helpful for NRSROs to disclose to investors their policies and procedures addressing conflicts of interest (as well as the conflicts themselves), and periodically to disclose information sufficient for investors to evaluate whether they have the necessary staffing, resources, structure, internal procedures and issuer contacts to serve as NRSROs. The call for increased transparency on these subjects is not new. In its report on the role of credit rating agencies, submitted pursuant to the Sarbanes-Oxley Act of 2002, the SEC noted that at its hearings on credit rating agencies, representatives of buyside firms, including mutual funds, had stressed the importance of increasing transparency in the ratings process.

We believe the public disclosure of this information would allow investors a continuous opportunity to evaluate an NRSRO's independence and objectivity, capability and operation. Such disclosure would serve as an effective additional mechanism for maintaining the integrity and quality of credit ratings.

VI. NRSROS SHOULD BE ACCOUNTABLE FOR THEIR RATINGS PROCESSES

NRSROs should assume some accountability for their ratings in order to provide them with incentive to analyze information critically and to challenge an issuer's representations. Under current regulations, the SEC exempts NRSROs, but not other rating agencies, from treatment as experts subject to liability under Section 11 of the Securities Act of 1933 and, thus, allows NRSRO ratings in prospectuses and financial reports. Although the SEC has stated that NRSROs remain subject to antifraud rules, the NRSROs have steadfastly maintained that, under the First Amendment, they cannot be held liable for erroneous ratings absent a finding of malice.

Notwithstanding whether NRSROs can or should be held liable for an erroneous rating itself, we believe that any reforms to the credit ratings process should, at a minimum, make NRSROs accountable for ratings issued in contravention of their disclosed procedures and standards. Even if the First Amendment applies to credit ratings, it does not prevent Congress from requiring rating agencies to make truthful disclosures to the SEC and to the investing public. H.R. 2990 should therefore be modified to provide that if a rating agency obtains an NRSRO designation based on, for example, a specific ratings process, it should be held accountable to the SEC and to investors if it fails to follow that process.

VII. CONCLUSION

The SEC has been aware of issues relating to credit rating agencies for over a decade now. During that time, the SEC has issued two concept releases, two rule proposals and a comprehensive report to Congress addressing credit rating agencies and NRSRO practices. In the process, the SEC has received scores of comment letters, including several from the Institute, urging action in this area. None has been forthcoming. In light of this history, action by Congress is now necessary.

The Institute strongly supports the goals of H.R. 2990. The increased competition that the bill should facilitate, combined with appropriate SEC oversight, greater transparency to investors, and NRSRO accountability, would benefit mutual funds and other investors and help secure reliable and credible ratings.

I very much appreciate the opportunity to share the Institute's views with you today. We have several technical comments about the bill that we will be providing, and do look forward to working with the Committee on these and other issues in the months ahead.

fei
financial executives international

June 9, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Definition of Nationally Recognized Statistical Rating Organization (File Number S7-04-05)

Dear Mr. Katz:

Financial Executives International's (FEI) Committee on Corporate Finance (CCF) appreciates the opportunity to comment on the Securities and Exchange Commission's proposed rulemaking that would define the term "nationally recognized statistical rating organization" ("NRSRO"). The proposed definition is comprised of a three-part, conjunctive test as follows: An NRSRO would be defined as an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.

The Commission states that it is seeking comment on the various components of the definition, as well as on the interpretations provided by Commission staff. The issues raised by the Commission in the proposed rulemaking are important. In the interest of efficiency, we will focus our comments on the major questions raised in the proposed rule.

Publicly Available Credit Ratings: The Commission asks how it should determine whether an NRSRO is making its credit ratings available on a widespread basis. The

Commission states that it is interpreting "publicly available," as used in the definition, to mean that credit ratings used for regulatory purposes under Commission rules must be disseminated "on a widespread basis at no cost."

We urge the Commission to require NRSROs to make their ratings available either by Internet or by phone. The final rulemaking should specify the acceptable methods for making the ratings public. We do not necessarily agree with the Commission's interpretation that such ratings should be available at no cost. This implies that the cost of ratings must always be borne by the issuers. As an alternative, we would suggest that the term "publicly available" can also include a nominal fee or subscription service whereby users of securities ratings would help offset the cost of generating such ratings.

On a related note, we believe NRSROs should be required to publicly disclose, at least annually, their breakdown of ratings by rating level (i.e., the percentage of their ratings that are AAA, AA, A, etc.), and the number of ratings the breakdown covers. They should also disclose their default rates by rating category for historical periods. This information would enable investors to see how NRSROs compare with each other.

Issue-Specific Credit Opinions: The Commission asks whether a credit rating agency that does not rate specific securities or money market instruments should qualify for NRSRO recognition. In its discussion of this issue, the Commission notes that the risk of loss on different debt instruments of the same issuer can vary considerably depending on the terms written into a security's legal documentation. Therefore, applying a single "issuer" rating to all an issuer's outstanding debt instruments could be misleading.

We concur with the Commission's analysis of this issue, and encourage the Commission to limit NRSRO status to credit rating agencies that rate specific securities or money market instruments rather than only providing "issuer" ratings.

Current Credit Opinions: The Commission asks whether it should provide additional interpretation regarding what it means for a credit rating agency's credit ratings to be "current assessments." The Commission interprets "current assessments" to mean that a credit rating agency's public credit ratings reflect its opinion as to the creditworthiness of a security or money market instrument as of the time the rating was issued and until the rating is changed or withdrawn.

Under this interpretation, the Commission states that a credit rating agency could meet the "current assessment" element if it follows procedures designed to ensure that its ratings are reviewed and, if necessary, updated on the occurrence of material events, including significant sector or issue-specific events.

We believe that disclosure – not regulation – is the appropriate method for addressing the issue of timeliness. By simply requiring credit rating agencies to date every rating, review, and outlook, the Commission would enable investors to judge for themselves how current a company's credit rating is. Requiring credit rating agencies to update their ratings whenever a "material event" occurs becomes problematic when one tries to define what is meant by "material event." Broadly defined, it would prove extremely onerous for the

credit rating agencies as they would be forced to constantly update their ratings. Narrowly defined, it would permit material events to occur without triggering the updated review, and would therefore lead investors to believe that a company's creditworthiness had not changed when in fact it may have.

We believe one simple, bright-line rule would make sense: NRSROs should be required to update their ratings at least annually. This would ensure that published credit ratings are never grossly out of date.

General Acceptance in the Financial Markets: The Commission asks, among other questions, whether the views of issuers should be a relevant consideration in determining whether a credit rating agency satisfies the "general acceptance" criteria. In its discussion of this issue, the Commission notes that it makes sense to link the evaluation of a credit rating agency's ratings to the views of the predominant users of securities ratings. Predominant users include financial market participants who hold large inventories of proprietary debt securities, preferred stock, and commercial paper, such as broker-dealers, mutual funds, pension funds, and insurance companies.

We believe issuers and qualified investors should also be classified as predominant users, and their views should be taken into consideration when weighing whether a credit rating agency satisfies the "generally accepted" criteria. Issuers and qualified investors maintain pension funds; possess –at times – significant cash investments; and oversee 401(k) funds. Taken together, these items comprise a significant part of the debt market, and therefore require issuers and qualified investors to be heavily involved in the markets. In addition, issuers and qualified investors interact with the rating agencies on a regular basis, and as a result possess significant insight and knowledge about the rating agencies. It would therefore seem prudent to solicit the views of both groups when evaluating rating agencies under this component of the definition.

Limited Coverage NRSROs: The Commission asks whether a credit rating agency should be recognized as an NRSRO if it issues credible and reliable ratings within a limited sector or geographic area. In its discussion, the Commission states that a credit rating agency that has developed a general acceptance in the financial markets could meet the NRSRO definition. In such instances, their market acceptance was based on the credibility and reliability of their ratings.

We believe agencies that provide limited sector coverage and limited geographic area coverage should be eligible for NRSRO status. Rating agencies that focus on a specific sector or industry should be eligible provided that the entire industry or sector is covered, and provided that the agency discloses its limited focus.

Likewise, credit rating agencies that provide limited geographic coverage should be eligible for NRSRO recognition provided they disclose their limited focus. While we recognize that most industries today are global in nature – which would mitigate against permitting rating agencies to focus on specific geographic areas – we nevertheless believe that disclosure is the key. So long as investors understand that a rating agency is providing

ratings for a specific geographic area only, they will be able to assess the credibility and reliability of such ratings.

Analyst Experience and Training: The Commission asks for comment on the appropriate subjective criteria that a credit rating agency should use in assessing the experience and training of an analyst to meet the proposed NRSRO definition.

In this instance, we believe bright-line rules clarifying the education, training, and experience requirements of both staff and credit committee members are appropriate. Staff and credit committee members should be required to have a minimum number of continuing education credits every year; they should also be required to have a minimum level of risk-based training. Lastly, analysts should be required to disclose the number of years they have covered a particular issuer. Such requirements would assure the investing public that analysts possess an appropriate understanding of the issues impacting a company's creditworthiness.

Number of Ratings per Analyst: Here, the Commission asks whether a credit rating agency's ratings may become less reliable as the number of issues per analyst increases. In its discussion of the issue, the Commission states that a credit rating agency should be able to demonstrate to users of its securities ratings that its analysts are capable of continuously monitoring and assessing relevant developments relating to their ratings. Thus, the number of ratings per analyst could be an important consideration for users of securities ratings in assessing whether a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings.

We view mandatory disclosure as the appropriate method for addressing this issue. Rating analysts should simply be required to disclose the number of companies and industries they rate. We further believe that rating agencies should be required to disclose their analyst rotation policies – if any – and the amount of time that an analyst has served as the lead analyst on a company that he or she is rating. These disclosures should enable investors to evaluate the credibility and reliability of various analysts' ratings.

Contacts with Management: The Commission asks whether a credit rating agency seeking to meet the definition of NRSRO should address the method and extent to which it involves an issuer's senior management in the rating process. The Commission posed a similar question in its 2003 Concept Release, and received differing viewpoints. Several commenters indicated that obtaining senior management's views could enhance a credit rating agency's ability to assess the quality and credibility of an issuer's management and better understand the issuer's operational and financial condition. Others worried that requiring contact with senior management could act as a barrier to entry for smaller credit rating agencies that cannot compel issuers to engage in a dialogue.

We believe it is extremely important that NRSROs maintain close contact with an issuer's management and staff. The subjective component of the rating is perhaps the most important part, and cannot be properly completed without close contact with the issuer's management and staff. However, we acknowledge that requiring contact with issuer management could serve as a barrier to entry for smaller rating agencies. We also

acknowledge that issuer management might be less inclined to speak with credit rating agencies issuing lower ratings. We therefore believe the appropriate solution is disclosure: rating agencies should be required to disclose when their analysts last held substantive meetings with senior management, who they met with, and where the meeting took place. The market would then decide how much importance to place on such contact, and therefore how credible the subjective portion of the rating is.

Conflicts of Interest: The Commission asks what specific conflicts of interest should be addressed in a credit rating agency's procedures and how they should be addressed. The Commission further asks whether a credit rating agency that engages in activities that present potential or actual conflicts of interest should be excluded from the definition of NRSRO. The Commission notes that reliance on issuer fees by a credit rating agency could lead to conflicts of interest and the potential for rating inflation.

We believe a simple bright-line rule similar to the restrictions included in Title 2 of the Sarbanes-Oxley legislation would serve best: Rating agencies should not be permitted to provide both advisory, fee-based services and rating services to an issuer. This restriction should eliminate any concerns regarding rating inflation. In addition, we believe that NRSROs, their related entities, and their Officers and Directors should be required to disclose all of their business dealings with issuers, not just the fee-based services they provide. Finally, we believe credit rating agencies should be required to identify the types of conflicts of interest that arise in its business; its procedures designed to address and minimize or avoid those conflicts; and how the firm monitors and verifies compliance with those procedures.

Misuse of Nonpublic Information: The Commission asks whether a credit rating agency should be required to demonstrate that it has systematic procedures designed to prevent the misuse of material nonpublic information. The Commission notes that some credit rating agencies, as part of their analysis, maintain contact with senior management of the issuers they rate. In the course of these contacts, an issuer may provide an analyst with nonpublic information such as contemplated business transactions or estimated financial information. There is a potential that this information could be used by a credit rating analyst or others for improper purposes. In response, the Commission proposes that to meet this component of the NRSRO definition, a credit rating agency should adopt procedures governing the receipt and use of nonpublic information that applies to all employees.

We agree that NRSROs need to demonstrate that they have adequate procedures and practices in place to prevent the misuse of nonpublic information. Perhaps NRSROs should be required to implement and maintain firewalls to ensure that nonpublic information is both segregated and secure. In addition, we think a bright-line rule is also in order: the SEC, or another government authority, should certify these processes and procedures annually.

Financial Resources: Here, the Commission asks whether a credit rating agency should be required to make its audited financial statements readily available to users of securities ratings in order for such users to assess whether a credit rating agency has sufficient financial resources to satisfy the third component.

Once again, we support a disclosure requirement, and specifically urge the Commission to require credit rating agencies to disclose information relating to the percentage of revenue it receives from particular issuers or subscribers as compared to the credit rating agency's total revenues. Such information would prove useful to users of securities ratings, as it would help "paint a picture" of the company issuing these ratings. For example, if a credit rating agency generated substantial revenue from a relatively small group of issuers, a user of that rating agency's ratings might question the objectivity and/or accuracy of the ratings given to that small group of issuers.

Statistical Models: The Commission asks whether a credit rating agency that relies solely or primarily on statistical models should be able to meet the proposed NRSRO definition. The Commission notes that commenters on the 2003 Concept Release generally agreed that computerized statistical models may be helpful in the credit rating process, but that a credit rating agency that solely uses statistical models should not qualify as an NRSRO.

We believe that sole reliance on statistical models should not be allowed by NRSROs. It is our belief that the interaction with management and general understanding of the issuer's business and financial risks are far more critical in determining a rating than anything generated from a statistical model. For example, an issuer's financial culture of "aggressive," "moderate," or "conservative" is much more important than any metric (e.g., funds to debt ratio). Furthermore, we believe that whenever NRSROs use statistical models to help develop their ratings, they should be required to disclose any instances where ratings are inconsistent with the quantitative measures used.

Provisional NRSRO Status: The Commission asks whether its proposed NRSRO definition and approach for promoting competition address the competitive concerns raised by commenters supporting provisional NRSROs. In its discussion of the issue, the Commission notes that the 2003 Concept Release sought comment on whether to consider a provisional NRSRO status for credit rating agencies that comply with NRSRO recognition criteria but lack national recognition. Commenters supporting provisional NRSROs indicated that permitting such recognition could promote competition among credit rating agencies by facilitating the entry of high-quality but lesser-known credit rating agencies. Commenters opposing the idea expressed concern that permitting two classes of NRSROs would likely cause confusion in the marketplace.

The Commission now wonders whether a better approach would be to award provisional status to credit rating agencies that confine their activities to limited sectors of the debt market or to limited geographic areas.

We believe the Commission's initial approach – to award provisional status to credit rating agencies that meet all of the criteria but lack national recognition – better serves the purpose of promoting competition among credit rating agencies. Recognizing high quality rating agencies that only lack national recognition would lower the barriers to entry, and would enable such rating agencies to develop the recognition they require to qualify for full NRSRO status. Provided such provisional status is fully disclosed to users, there is no reason to believe that a provisional classification will create marketplace confusion.

In summary, CCF encourages the Commission to support – whenever possible – disclosure requirements rather than "cookie cutter" regulation. We firmly believe that requiring credit rating agencies to disclose pertinent information to users of securities ratings will enable those users to weigh the credibility and reliability of such ratings. Much of the credit rating process involves judgment, which we believe cannot effectively be "regulated." Letting the markets evaluate the credibility of credit rating agencies would seem more prudent from a user's perspective and less onerous from the credit rating agencies' perspective.

CCF appreciates the opportunity to comment on the proposed rulemaking. Should you have any questions regarding our comments, please contact Mark Prysock at 202-626-7804.

Sincerely,

Dennis Ling

Dennis Ling
Chairman
FEI Committee on Corporate Finance

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation

fei
financial executives
international

November 29, 2005

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets, Insurance and Government
United States House of Representatives
Washington, DC 20515

Dear Chairman Baker:

Financial Executives International's (FEI) Committee on Corporate Finance (CCF) appreciates the opportunity to comment on H.R. 2990, the "Credit Rating Agency Duopoly Relief Act of 2005." As drafted, the legislation would eliminate the current "no action" process for recognizing statistical rating organizations; establish mandatory procedures for registering statistical rating organizations; and define the circumstances under which such organizations could be censured and/or suspended. The legislation would require registered rating organizations to prevent the misuse of non-public information; and to manage potential conflicts of interest, an issue we as group feel very strongly about.

FEI is a professional association representing the interests of more than 15,000 chief financial officers, treasurers, controllers, tax directors, and other senior financial executives from over 8,000 major companies throughout the United States and Canada. FEI represents both providers and users of financial information. The FEI Committee on Corporate Finance formulates policy on treasury-related issues for FEI in line with the views of the membership. This letter represents the views of the Committee on Corporate Finance.

Since CCF filed formal comments with the SEC on its pending Nationally Recognized Statistical Rating Organization (NRSRO) rulemaking, and since those comments reflect our current thinking on rating agency matters, we are formally submitting those comments for your consideration as the Committee deliberates on these important matters.

We would like to elaborate on one point made in our SEC submission: NRSROs offer a wide range of fee-based, advisory services to the general public, including their "rated"

clients. Other than ratings assessments instigated at the behest of an issuer, which we believe are appropriate, we believe rating agencies should be restricted from offering other such services to their rated clients since provision of such services can create a potentially conflicting relationship with the issuer.

We believe a simple, bright-line rule similar to the restrictions included in Title 2 of the Sarbanes-Oxley legislation would serve best: Rating agencies should not be permitted to provide both advisory, fee-based services and rating services to an issuer. In addition, we believe that NRSROs, their related entities, and their officers and directors should be required to disclose all of their business dealings with the issuers, and not just the fee-based services they provide. Finally, we believe that credit rating agencies should be required to identify the types of potential conflicts of interest that arise in its business; its procedures designed to address and minimize or avoid those conflicts; and how the firm monitors and verifies compliance with those problems.

Again, we applaud your efforts to generate greater transparency and competition in the rating agency sector. Both investors and issuers stand to gain by having more information about the rating agencies available to them, and more rating agencies to choose from. CCF stands ready to continue working with the Committee to strengthen this legislation as it moves forward, and urges Congress to enact this important legislation as soon as possible.

Sincerely,

Dennis Ling

Dennis Ling
Chairman
FEI Committee on Corporate Finance

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